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8

Commercial Leases Overview

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Top Ten Most Important Things to Consider
When Reviewing a Commercial Lease
For a Professional Services Firm

*** Summary Page ***

I. **The Work Letter and the Commencement Date**: who builds; allowances; payment schedule; takeover rights for non-performance; how to measure commencement date; interrelationship with substantial completion definition.

II. **Exit Strategies**: assignment and subletting rights; addressing growth and shrinkage; lease buyout negotiations.

III. **Expansion Rights**: options; RFRs; RFOs; must-take.

IV. **Operating Expenses**: base year; inclusions and exclusions; audit rights.

V. **Insurance**: dealing with terrorism and earthquake insurance requirements; relationship to indemnity and damage-and-destruction provisions; liability versus property coverage; business interruption and loss of earnings; self-insurance.

VI. **Services and Utilities**: protection of Tenant *vis-à-vis* other tenants of Building; focus on sufficient power and meeting Tenant's special utility requirements.

VII. **Tenant Repairs**: protect right of self-help where Landlord is or may be "off-shore" or otherwise not able to respond immediately with local representation.

VIII. **Premises**: focus on issues of measurement, relocation, visibility, access, signage and other personal rights.

IX. **Security Deposit**: negotiate to minimize amount of funds tied up as security; understand and negotiate issues of guaranties and letters of credit.

X. **Surrender of Premises; Removal of Property**: coordination with alterations provision; holdover issues and rates; eliminate surprises.

- **Special issues relating to retail tenants**: use; radius restrictions; cotenancy; operating covenants; go-dark rights; parking; exclusive parking spaces; preferred areas; sightlines; modifications; reciprocal easements.

- **Special issue for Tenant's attorney**: subordination, non-disturbance and attornment agreement from lenders and other entities with priority over Tenant's Lease.

I. THE WORK LETTER AND THE COMMENCEMENT DATE

A. Base building description—landlord's cost and expense

1. Critical to determining sufficiency of allowance
2. Apples to apples when comparing alternatives

B. Landlord-build

1. Tenant improvement allowance vs. turnkey
2. Substantial completion/ready for occupancy
3. Tenant delay concept

C. Tenant-build

1. Fixed start date
2. Landlord delay/force majeure delay concept
3. Impact on time and money
4. Sophistication of tenant or tenant's consultants

D. Working drawings

1. Schedule of approvals
2. Selection of architect
3. Required use of landlord's engineers

E. Cost estimates

1. Over-allowance negotiations
2. Change orders

F. Fine-tuning

1. Utility costs
2. Use of hoists
3. Parking

II. EXIT STRATEGIES

A. Assignment and subletting

1. Continuing liability
2. Distinction between assignment and sublease
3. Landlord consent
   (a) Reasonableness standards
   (b) Remedies; potential limitations based on consent standards
4. Recapture
   (a) Impact on tenant's sublease marketing abilities
   (b) Consider landlord right of first offer
5. Profit sharing
6. Transfers of shares/interests in tenant—sale of tenant's business
7. Tenant affiliates
8. Restrictions on transfer of personal rights
9. Nondisturbance of assignee or subtenant
10. Release of tenant/assignor

B. Kick-out rights

1. Minimum term
2. Termination payment
3. Shopping center and retail leases

C. Negotiated termination of lease

1. Elements of consideration
2. Impact on subtenants

III. EXPANSION RIGHTS

A. Option to expand

B. Right of first refusal

C. Right of first offer

D. Must-take space

IV. OPERATING EXPENSES

A. Landlord's goals

B. Tenant's goals

C. Specific provisions

1. Tenant's pro rata share

2. Gross-up

3. Base year/expense stop/triple net

4. Review of inclusions

(a) Energy- or other cost-saving capital expenditures

(b) Unforeseen governmental requirements

5. Negotiation of exclusions

(a) Capital repairs and replacements

(b) Compliance with law expenses (*Brown v. Green*)

(c) Removal of asbestos/toxics

(d) Costs of casualty and condemnation repairs/relationship to capital repairs and replacements

(e) Controllable operating expenses

D. Audit rights

1. Alternative: right to an accounting

2. Use of commission-based auditors

V. INSURANCE

A. Liability insurance

1. Occurrence basis

2. Commercial general liability policy

B. Property Insurance

1. Terrorism coverage—if added after Base Year, reach back to increase Base Year line item for insurance premiums (see materials at pages C-1 to C-11)

2. Earthquake coverage—if added after Base Year, reach back to increase Base Year line item for insurance premiums

C. Boiler and machinery breakdown coverage

D. Builder's risk

E. Completed operations coverage

F. Commercial general liability policy (contractors)

G. Business interruption insurance

H. Rental loss insurance

I. Special coverage for unique uses

J. General requirements

1. Landlord approval

2. Lender approval

3. Primary coverage

4. Rating/financial strength

5. Additional insureds

6. Certificates of insurance/delivery of policy

7. Contractual liability

8. Deductible

9. Increased insurance

K. Self-insurance

L. Waiver of subrogation

VI. SERVICES AND UTILITIES

A. Assure that Landlord is not deviating standard hours of operation for any other single tenant without appropriate adjustments in favor of Tenant.

B. Assure that holiday hours and Saturday hours are consistent with operational requirements of Tenant to the extent possible; outside of Building hours the Tenant will pay for services and utilities as an extra.

C. Be sure that the wattage per rentable square foot granted to tenants generally within the Building is sufficient to meet Tenant's requirements without having to add special equipment or pay for "overtime" rates.

D. Include HVAC specs in lease if possible; otherwise require the Lease to deliver a comfort standard similar to "comparable buildings" (*i.e.*, buildings of comparable age, construction specifications, size and location).

E. Negotiate for rental abatement rights after minimum interruption of use (*e.g.* three days).

VII. TENANT REPAIRS

A. Attempt to negotiate Tenant right of repair for and offset if Tenant has leverage and in all cases where the Landlord is not locally based or under contract with Class A local management.

B. Agree to use Landlord's list of vendors if Landlord provides such a list and it is pre-approved by Tenant.

C. Require offset rights, but be prepared to grant a right to arbitrate if Landlord provides written objections followed by an offset right if judgment or award not paid in 30 days.

VIII. PREMISES

A. Be clear as to measurement of Premises; tie to customary use of BOMA as interpreted by the owners of the Comparable Buildings.

B. Restrict Landlord's relocation rights, and where leverage does not allow for deletion of the relocation provision assure that all direct and indirect costs are covered, and relocation occurs over a weekend.

C. Confirm visibility and access where those issues are critical to Tenant; negotiate for signage and other special personal perks such as special parking.

IX. SECURITY DEPOSIT

A. Be clear that the Tenant has approved any increase in the security deposit based on "stepped rent."

B. Attempt to negotiate an interest credit, but be realistic relative to space which is less than 15,000 rentable square feet; take into account the fact that security deposits are typically used to pay brokerage commissions and TIs and, to such extent, doesn't actually earn interest.

C. Be prepared to address requests for personal guaranties and letters of credit; if a personal guaranty is required, it should be limited to specific levels of rental defaults and should "burn down" as soon as reasonably possible after demonstration of consistent performance. Be sure Tenant has sufficient collateral before agreeing to deliver a letter of credit.

X. SURRENDER OF PREMISES; REMOVAL OF PROPERTY

A. Be as specific as possible regarding Tenant's duties, as this is a hotbed for litigation.

B. Items that Tenant would expect to leave in the Premises at the end of the term, such as cabling and built-ins, should be specified.

C. This provision and the alterations provision need to be synchronized so that when approval of an alteration is requested, the Landlord commits up front as to whether or not Tenant must remove such item on surrender.

D. Negotiate a reasonable breathing period for holdover at the existing or slightly increased rental before agreeing to 150% or 200% rental increases. This situation will likely be out of the control of Tenant, as its new space may not be timely available.

Sample Tenant Representative Negotiation Guideline

The attached guideline utilized by a multi-location office credit tenant identifies lease issues and categorizes them as being mandatory or desirable at the letter-of-intent stage, and, from that tenant's perspective as being mandatory or desirable at the lease-documentation stage. The checklist should be valuable in the preparation of the negotiation agenda for both the letter of intent and the lease.

A. Tenant

1. Mandatory in LOI

The Tenant shall be defined as _____.

B. Landlord

1. Mandatory in LOI

The Landlord shall be clearly defined. Landlord shall provide financial statements to Tenant for Tenant's review within 14 days from execution of the Letter of Intent.

C. Lender

1. Mandatory in LOI

The Lender(s) shall be clearly defined. The Lender(s) shall provide a fully executed Non-Disturbance Agreement acceptable to Tenant as part of the executed Lease Agreement.

D. Space (Use of Other Local Measurements Standards)

1. Mandatory in LOI

Tenant shall have the right to have its architect certify the usable and rentable square feet of the premises prior to Lease execution. Method of space measurement must be well defined.

2. Desirable in LOI

The leased premises shall be defined in strict accordance with BOMA standards.

3. Mandatory in Lease

The Building's RSF and Tenant's proportionate share of Building for purposes of operating expenses and taxes must be well defined.

4. Desirable in Lease

The actual rentable square footage of the premises and Tenant's proportionate share shall be adjusted to conform with BOMA standards based on certification by Tenant architect.

E. Use

1. Mandatory in Lease

The broadest definition of use should be incorporated in the Lease to facilitate subleasing. Tenant's use of the premises shall be defined in an office lease, for example, as "general office purposes."

F. Rent

1. Mandatory in LOI

Rent shall be clearly defined as either net rent or gross rent.

2. Desirable in LOI

In the case of gross rent, the base year shall be established as the first full year following Lease commencement.

3. Mandatory in Lease

Rent shall be defined as due and payable on the first day of each month, and Tenant shall not be considered to be "in default" until 10 days following written notice from Landlord.

G. Operating Expenses

1. Mandatory in Lease

Operating expenses shall be defined to include operating expenses incurred in connection with the management, operation, repair and maintenance of the property by the Landlord and determined in accordance with generally accepted accounting principles fairly and consistently applied. This definition would include management fees. It is important to place a market-based cap on management fees. It is important to maximize the exclusions from operating expenses. The following serves as a representative list of exclusions:

(a) The cost of any addition to the building or alterations or refurbishment of space leased to other tenants in the building.

(b) Real estate commissions or brokerage fees.

(c) Legal fees and all other costs in connection with tenant leases and enforcing tenant obligations.

(d) Marketing and advertising expenses incurred with the leasing of the building.

(e) Costs incurred by the Landlord which are reimbursed by insurance.

(f) Financing transactions.

(g) Interest or amortization.

(h) Variable expenses in a less than fully occupied building shall be calculated assuming 95% occupancy. Tenant's proportionate share shall be specifically defined.

(i) Refinancing fees and any interest payments or late penalties.

(j) The amortization of any capital expenditures including capital expenditures incurred to comply with existing laws and other governmental rules and regulations. (The amortization of capital expenditures which reduce annual operating expenses by an amount in excess of the annual amortization of the capital expenditure shall be allowed.)

(k) Depreciation and amortization of any building and equipment. (See above exception.)

(l) Costs to comply with all government regulations.

(m) Operating expenses of any associated garage.

(n) Special services performed by landlord for the benefit of individual tenants.

(o) Charitable contributions.

(p) Expense for artwork.

(q) Off-site management and overhead.

(r) Wages and salaries of supervisory and executive personnel over and above the on-site property manager.

(s) All amounts paid to subsidiaries or affiliates of the Landlord for services on or to the building which are in excess of competitive costs for such services.

(t) Landlord's general partnership overhead.

(u) If Landlord increases the building's rentable square feet, then Tenant's proportionate share shall be reduced using the formula set forth in Section ___ of the Basic Lease Provision.

(v) Any payments under a ground lease or master lease relating to the Project (while this is already addressed in interest and financing, we think it merits its own category).

2. Desirable in Lease

(a) Electric power or other utility costs for which any tenant directly contracts with the local public service company.

(b) Costs, penalties, fines, or awards and interest incurred as a result of Landlord's negligence in Landlord's operation of the Project, violations of law, negligence or inability or unwillingness to make payments and/or to file any income tax, or other tax or informational returns when due.

(c) Costs which are covered by and reimbursable under any contractor, manufacturer or supplier warranty or service contract.

(d) Costs arising from the negligent or intentional acts of Landlord or its agents, or any other tenant, or any vendors, contractor, subcontractors or providers of materials or services selected, hired or engaged by Landlord or its agents to the extent Landlord receives reimbursement therefrom.

(e) Costs arising from any type of insurance maintained by Landlord which is not required or allowed to be maintained by Landlord pursuant to this Lease.

(f) The cost of installing, operating and maintaining any specialty service, observatory, broadcasting facilities, luncheon club, museum, athletic or recreational club, or child care facility operated or supplied by a third party under an agreement between a third party and landlord

(g) The cost arising from any commercial concession operated by Landlord.

(h) The cost of any parties, ceremonies or other events for tenants or third parties which are not tenants of the Building, whether conducted in the Building, Project or in any other location.

(i) Reserves of any kind, including, but not limited to, replacement reserves, and reserves for bad debts or lost rent or any similar charge not involving the payment of money to third parties.

(j) Costs incurred by Landlord in connection with rooftop communications equipment of Landlord or other persons, tenants, or occupants of the Building or the Project if such communications equipment is not generally available to all tenants or occupants of the Building or Project.

(k) Costs relating to any management office for the Building including rent, or for any other management office in the Project. (Fallback in a high-rise office building to allow Operating Expenses to include rent for up to 2,000 rentable square feet of a Building management office at rates then being generally charged for the middle floors of the Building.

(l) "Takeover" expenses, including but not limited to expenses of any kind or nature incurred by Landlord with respect to space located in another building.

(m) Any costs and fees, dues contributions or similar expenses for industry associations or organizations in which officers or employees of Landlord are members.

(n) Entertainment expenses and travel expense of Landlord, its employees, agents, partners and affiliates.

(o) Any other expenses which, in accordance with generally accepted accounting principles, consistently applied, would not normally be treated as Operating Costs by landlords of comparable buildings.

(p) Any costs for which Landlord has been reimbursed or receives a credit, refund or discount.

It is important to minimize management fees and either provide a cap on the amount of the management fees and/or a cap on the growth of the management fees. Three percent (3%) of the gross rent is an achievable cap on management fees.

H. Right to Audit Expenses

1. Mandatory in Lease

Tenant or its agent shall have the right to audit operating expenses. This right shall continue for at least 90 to 180 days following the date that the Landlord provides Tenant with the previous year's audited operating expenses.

2. Desirable in Lease

Tenant has the right to audit previous years if a discrepancy in excess of 3% is determined.

Landlord will reimburse Tenant for the cost of the audit if a discrepancy of at least 5% is found.

I. Occupancy & Delivery of Space For Tenant-Build Work Letters

1. Mandatory in LOI

Tenant shall have the ability to take occupancy of the premises at least [90 to 120] days in advance of the commencement date for construction. The premises shall be turned over to Tenant in base building condition. Tenant shall not be charged for electricity or other services during the pre-commencement period.

2. Desirable in LOI

Tenant shall have the right to occupy the premises on a full or partial basis up to 60 days prior to commencement date with no rental charge or expense charge for this pre-commencement occupancy period.

Longer periods than 90 days for Tenant to construct its improvements prior to rent commencement is highly desirable.

J. Base Building

1. Mandatory in LOI

Base building shall be defined to include all structural elements of the building, elevator system, washrooms, fire exit stairways, electrical risers, telephone risers, plumbing risers, sprinkler systems, air distribution system and air handling loop, including VAV boxes, janitorial closets, telephone closets, and electrical closets. Specific language should include:

(a) The primary and secondary electrical, mechanical, fire protection, and life safety systems distribution shall be in accordance with the Base Building Design and shall comply with the Local Building Code and other requirements of governmental agencies including ADA having jurisdiction over the Building, collectively, the "Building Regulations," for unoccupied office space in shell condition and shall be in good working order.

(b) The area intended for Tenant's Leasehold improvements shall be clean and free from any debris.

(c) Concrete floor slabs shall be level to within ¼" cumulative deviation with ten (10) feet between any two points in the premises and two (2) inches cumulative between any two corners of the Building.

(d) Perimeter walls and core walls shall be fully finished, ready for paint, and all exterior columns shall be furred out, enclosed, taped, spackled, sanded,

and primed, ready for paint. All such work shall comply with all applicable building codes.

(e) Restroom facilities in compliance with ADA for men and women and two drinking fountains shall be located on each floor of the premises.

(f) All peripheral windows will have thin slat horizontal blinds in standard color installed after completion of Tenant's Work in the Initial premises.

(g) A fully operational life safety system with smoke detectors, fire alarm speakers, fire extinguishers and cabinets in common areas, exit lights, and emergency circuitry in full compliance with Building Regulations for Base Building Design and ADA.

(h) The Base Building heating and air conditioning system (HVAC) shall comply with the state and local building codes, the standards established by the American Society of Heating, Refrigeration, and Air Conditioning Engineers (ASHRAE) for high-rise office buildings, or such other standards customarily adopted for Class A high-rise office buildings in the local area.

(i) Where the premises are located on a multi-tenant floor(s) of the Building, the Landlord shall be responsible for providing all construction requirements pertaining to public areas such as elevator lobbies and corridors at Landlord's sole expense.

(j) Landlord shall provide chilled water for supplemental 24-hour cooling.

(k) Landlord shall eliminate any non-tenant-caused Base Building and common area electromagnetic field (EMF) issues.

2. Desirable in LOI

The ASHRAE 1% design day should be used in establishing performance specifications.

K. Allowances

1. Mandatory in LOI

A tenant improvement allowance of $_____ per RSF shall be provided. Landlord pays contractors directly upon invoice approval by Tenant. Tenant shall have the right either to credit any unutilized allowances against base rent next due or to apply the unutilized allowance to supplement any other allowance category.

2. Desirable in LOI

A repainting and recarpeting allowance of $5.00 per RSF shall be included in the sixth and eleventh lease years.

A design allowance of $3.00 per RSF and a moving allowance of $2.00 per RSF shall be provided. In addition to tenant construction, allowances may be used for cabling, consultant fees, permits and permanently attached furniture.

L. Allowances, Right to Offset

1. Mandatory in LOI

Tenant shall have the right to offset against rental payments any shortfalls in payments of allowances. The amount of offset shall be equal to the shortfall in the allowance payment, plus an interest factor.

M. Structural Modifications

1. Desirable in LOI

Landlord shall provide Tenant with a reinforced floor area to accommodate high-density storage file areas (at no cost to Tenant).

N. Internal Stairways

1. Desirable in LOI

Tenant shall have the right to utilize fire stairs or install an internal staircase within the premises and shall not be required to remove the stairs at the end of the Lease term.

O. Right to Hire Contractor

1. Mandatory in LOI

If Tenant is required to utilize Landlord's contractors, Tenant must maintain schedule and cost controls. Landlord's supervisory fees will be minimized and capped.

2. Desirable in LOI

Tenant shall have the right to hire the general contractor and the project manager of its choice for the tenant improvement work without any obligation to hire or use the Landlord's contractor.

P. Tenant Construction

1. Mandatory in LOI

Tenant shall not be charged for any hoisting charges, electrical services, water or the use of freight elevators during the construction period.

2. Desirable in LOI

Landlord shall not charge any oversight fees or supervisory fees during the construction period.

Q. Alterations

1. Desirable in LOI

Tenant shall have the right to make minor alterations to the premises, which are not structural in nature, including painting and carpeting without the prior consent of the Landlord.

2. Mandatory in Lease

For alterations other than "minor," Landlord shall approve or disapprove Tenant's alteration request within 10 days of receipt of written request which includes applicable plans and specifications. If Landlord disapproves such request, Landlord shall explain in writing its reasons for disapproving.

R. Restoration Obligation

1. Mandatory in LOI

Leasehold improvements paid for by Landlord are property of Landlord. Tenant shall not be obligated to restore the premises at the end of the lease term, except for items not typically found in offices and substantially add to Landlord's demolition costs (vaults, internal stairs, etc.)

S. Pre-Occupancy Contraction/Expansion

1. Desirable in LOI

Tenant shall have the right to expand the rentable square feet under the Lease by up to 10% prior to occupancy under the same terms and conditions of Lease. Tenant shall also have the right to contract the rentable square feet under the Lease by up to 10% prior to occupancy.

T. Expansion Options

1. Mandatory in LOI

Tenant shall have expansion options through their term. The amount of expansion space should be determined by growth projections provided by the practice office and modeled by the Real Estate and Office Planning Department. Rent for expansion space will be at prevailing market rental rates as described in the "Extension Option" section.

2. Desirable in LOI

Rent for expansion options shall be at the then current Lease rates, including a pro rata share of concessions and tenant improvement allowances initially provided.

U. Continuing Right of First Notice

1. Mandatory in LOI

Tenant shall have a continuing Right of First Offer for a specified block of space.

Rent for expansion space will be at prevailing market rental rates as described in the "Extension Option" section.

2. Desirable in LOI

Tenant shall have a continuous Right of First Offer and Right of First Refusal with respect to space in the building that is contiguous to Tenant's premises or in the same elevator bank or for the entire building depending on projected growth ranges for the practice office.

Any space acquired under the Right of First Offer will be added to Tenant's Lease at the then escalated rate with prorated allowances.

V. Contractual Options

1. Mandatory in LOI

Tenant shall have the right to contract its leased premises periodically through the Lease. (These contraction options should provide for at least a 20% reduction in space.)

Penalty amount and time of payment is specified.

2. Desirable in LOI

Tenant shall pay a penalty prior to the effective date equal to the unamortized tenant improvement allowances, commissions and other concessions.

W. Cancellation Options

1. Mandatory in LOI

Tenant shall have the right the cancel the Lease at the end of the fifth lease year in a ten-year lease.

penalty amount and time of payment is specified.

2. Desirable in LOI

If a 15-year lease is considered, Tenant shall have the right to cancel its Lease at the end of 10 years.

Tenant shall pay a penalty prior to the effective date equal to the unamortized tenant improvement allowances, commissions and other concessions.

X. Extension Options

1. Mandatory in LOI

Tenant shall have the right to renew the Lease at the prevailing market rental rate for two additional terms of five years each. The prevailing market rental rate shall be defined as the rental rate at the time Tenant provides notice for vacant space in buildings of comparable quality and age for tenants of similar size, credit quality and stature. The prevailing market rental rate shall include all comparable lease provisions including without limitation market provisions for improvement allowances, tenant procurement costs, free rent, other lease concessions, lease term, base years, lease rate escalations and operating expenses and taxes. Any dispute over the prevailing market rate shall be submitted to arbitration.

2. Desirable in LOI

The renewal rate will be at a specified Rent, have a Rent cap, or be at a percentage 80-95% of the prevailing market rental.

Y. Operating Hours and Overtime HVAC

1. Mandatory in LOI

Building hours of operation shall be 8:00 a.m. to 6:00 p.m., Monday through Friday, and 8:00 a.m. to 1:00 p.m. on Saturday.

Holidays shall be defined as Thanksgiving, Christmas, New Years Day, Memorial Day, Fourth of July and Labor Day.

2. Desirable in LOI

Building hours of operation shall be 7:00 a.m. to 7:00 p.m., Monday through Friday, and 8:00 a.m. to 2:00 p.m. on Saturday.

Tenant shall be allowed to have the greatest number of hours that can be negotiated of overtime HVAC for use as required at no additional cost to Tenant.

3. Mandatory in Lease

The cost for overtime HVAC shall be at a stated market-based rate, with a well-defined annual cap on increases.

4. Desirable in Lease

The cost for overtime HVAC shall be billed at the actual costs incurred by the Landlord for providing such service.

Z. Services

1. Mandatory in LOI

Landlord shall provide all services including HVAC, electric, utilities, telephone access, security, janitorial, etc., consistent with other Class A buildings in the metropolitan area. Fresh air levels shall be maintained in accordance with prevailing Class A standards and ASHRAE-62 - 1989 standards (ventilation for acceptable indoor air quality). The Landlord shall also provide adequate thermal environmental comfort and air velocity limits in accordance with ASHRAE-55.

2. Desirable in LOI

The ASHRAE 1% design day should be used in establishing performance specifications.

AA. Electrical Capacity

1. Mandatory in LOI

Landlord shall provide at least five watts per square foot of electrical capacity to the premises (in most instances six watts will be preferable), above base building lighting (i.e., lobbies, stairwells, restrooms, etc.).

BB. Cleaning Specifications

1. Mandatory in Lease

Cleaning specifications shall be attached to the Lease document. Tenant may compel a change in janitorial contractors.

Compare cleaning specifications to Tenant standard.

2. Desirable in Lease

Tenant shall have the right to contract for its own janitorial services and have operating expenses adjusted accordingly.

CC. Security

1. Mandatory in LOI

Landlord shall provide or Tenant shall have the right to install a controlled access system for the premises.

2. Desirable in LOI

Landlord shall provide adequate security, including 24-hour-a-day guard service.

DD. Interruption of Services

1. Mandatory in LOI

If building services are interrupted for more than three consecutive days, then Tenant shall have the right to cease its base rent and additional rent payments beginning with the day of interruption pro-rated until such service is reinstated.

2. Desirable in LOI

If the interruption shall continue for 60 days, Tenant shall have the sole right to terminate the Lease.

3. Mandatory in Lease

In the event that the premises are untenantable due to a casualty for a period in excess of 180 consecutive days from the date of casualty, Tenant shall have the sole right to cancel the Lease without payment of any termination fee; rent shall be abated from the date of casualty.

EE. Self-Help

1. Mandatory in LOI

In the event that the Landlord has failed to perform any of its service or maintenance within the Premises, then Tenant shall have the right to perform such maintenance or service and charge Landlord.

2. Desirable in LOI

Tenant may offset the associated costs against rent if Landlord does not pay Tenant's invoices.

FF. Assignment and Subletting

1. Mandatory in LOI

Tenant shall have the right to sublease all or a portion of the Premises with Landlord's approval, which shall not be unreasonably withheld. Landlord shall not impose any use limitation other than those previously defined in all other tenant leases in the building. Landlord shall not impose any financial requirements on the subtenant as a condition for approval. Landlord shall deliver approval to Tenant within 10 days following Tenant's request to sublease. Tenant shall have the right to assign the Lease or sublet all or a portion of the premises to the following entities without Landlord's approval: (i) to a successor to all of Tenant's businesses if such succession takes place by a merger, consolidation, reorganization, active legislature or otherwise, or (ii) any affiliate of Tenant.

2. Desirable in LOI

Tenant may sublet or assign the Premises to other tenants in the Building.

3. Mandatory in Lease

Tenant shall recover all its costs prior to any profit distribution. Profits shall be calculated by subtracting all subleasing expenses from sublease rental income. In addition to contract gross rent, expenses shall include all incentives, inducements, allowance, demising costs, commissions, legal fees, and landlord fees.

4. Desirable in Lease

Tenant shall retain 100% of sublease profits.

GG. Environmental Hazardous Materials

1. Mandatory in LOI

Landlord shall represent to Tenant that the building is free from EHM and that the Landlord will promptly remove any EHM found in the future at the Landlord's sole expense.

2. Desirable in Lease

Landlord shall indemnify Tenant for any Landlord non-compliance with governmental regulations.

HH. Americans with Disabilities Act

1. Mandatory in LOI

.Landlord shall comply with all governmental regulations. Landlord shall warrant that the building is currently in compliance with all government regulations. Landlord shall also be responsible to bring building and all common areas (including elevator lobbies, stairwells, rest rooms, etc. on floors fully occupied by Tenant) into compliance during the term of the Lease.

2. Desirable in LOI

Capital costs to comply with future government regulations, including ADA in common areas of the building, including bathrooms, will be borne by the Landlord and not included in operating expenses.

ADA compliance in rest rooms on full Tenant floors is Landlord's responsibility.

3. Desirable in Lease

Landlord shall indemnify Tenant for any Landlord non-compliance with governmental regulations.

II. Non-Recourse

1. Mandatory in LOI

No partner of Tenant shall have any personal liability for breach of any covenant or obligation of Tenant under the Lease, and no recourse shall be had or be enforceable against the assets of any partner of Tenant for any payment of any sums due to Landlord or for enforcement of any other relief based upon any claim made by Landlord for the breach of any of Tenant's covenants or obligations under the Lease.

JJ. Non-Disturbance

1. Mandatory in LOI

The Lease is contingent upon the execution of a non-disturbance agreement. The Lease shall contain a Non-Disturbance Agreement executed by the current Lender or lenders, as well as non-disturbance language protecting Tenant in the event of future sale or foreclosure. All terms of the Lease shall be protected by the Non-Disturbance Agreement.

KK. Holding Over

1. Desirable in LOI

Tenant shall have the right to extend the lease term by six months, subject to written modification to Landlord six months prior to the end of the term, at the then current rental rates.

2. Mandatory in Lease

Tenant shall have the right to holdover for up to one year, with rental rates not to exceed 150% of the Base Rent then being paid during the last year of Tenant's rent. Tenant shall not be liable for consequential damages for the first three months of holdover.

3. Desirable in Lease

Tenant shall have the right to holdover for up to one year at the rental rate in effect during the last year of Tenant's rent. Tenant shall not be liable for consequential damages.

LL. Arbitration

1. Desirable in Lease

Where arbitration provisions apply, arbitration procedures shall be defined in accordance with "baseball arbitration."

MM. Parking

1. Mandatory in LOI

During the term of the Lease, Tenant shall upon _____ days' notice to Landlord be able to increase or decrease the contracted spaces within its allocation.

The number of parking spaces allocated to Tenant and associated parking rates shall be specifically defined. Any parking rate increases shall be defined.

Tenant shall have the ongoing right to contract for allocated spaces, but not the obligation to contract for such spaces.

The methodology for increasing the number of spaces allocated in the event of an expansion shall be defined.

NN. Naming and Signage

1. Mandatory in LOI

The building shall not be named for any Tenant competitors, including "Big 6" competitors or "regional" competitors or their associated consulting subsidiaries.

2. Desirable in LOI

Tenant shall have the right to building monument or elevator lobby signage.

OO. Directory Listings

1. Mandatory in Lease

Tenant shall have a line item in the building directory identifying the firm, as well as line items for each partner in the practice office.

PP. Agreement

1. Mandatory in LOI

This Agreement does not create any legally binding obligation for either the Landlord or Tenant. Landlord shall remove the proposed premises from the market for a period of 90 days with the execution of this Letter of Intent.

Building A Reputation For Being A Deal Closer

A. Create A Sense of Urgency – "Time Kills All Deals"

1. Must Be Set For Principals and Lawyers

2. The Wrong Method

(a) Vacation Deadlines

(b) Board Meeting/Officers Meeting Announcement

(c) Commencement of Critical Event

(d) Increased Costs Under Status Quo

(e) Competition Will Awake

(f) Deal Will Be Killed

3. The Right Method

(a) Create a Realistic Step-by-Step Schedule

(b) Create Reciprocal Obligations

(c) Demonstrate Reciprocal Work Ethic

(d) Don't Schedule Around Social/Recreational Events

B. Create Efficiency

1. Respond in Writing

2. Trade Computer Disks/E-Mail

3. Be Prepared

4. Pre-Negotiated Documents

5. Control the Selection of Lawyers

6. Shorter Meetings

7. Multiple Meetings

8. Smaller Meetings

9. Limit Appearances by Principals

10. Table Business Issues

11. Dual Drafting/Resolution Tracks

12. Designate the Client/Business Conduit/Information Gatherer

13. Stroke the Lawyer

14. Don't Inefficiently Manipulate Timing

C. Bad Words

1. "Can We Do This Deal in a Week?"

2. "The Client Does Not Care What the Documents Look Like"

3. "The Deal Is Made – What's Taking the Lawyers so Long?"

4. "When Can we Get a Redraft?"

5. "This is a Below Market Deal"

6. "This is an Above Market Deal"

7. "We Never do That"

8. "We Always Get That"

9. "The Lender Won't Approve That"

D. Good Words

1. "Reasonable/Commercially Reasonable"

2. "Compromise"

3. "Good Faith"

4. "Non-Discriminatory"

5. "Best Commercially Reasonable Efforts"

E. Procedural Theories

1. The Race to Reasonableness

2. Don’t Get Personal

3. Quickly List Hot Button Issues and Move On

4. Don’t Renege or Review Once Completed

5. No Acting/No Ego/No Embarrassing

6. Solutions Are the Result of Multiple Minor Solutions

7. Sense of Equity Over time Can Solve Issues

8. Trade Listed Issues and Close Deal

F. Maximizing the Effectiveness of the Third Party Consultants

1. Learn Everyone’s Roles and Parts

2. Take Part in Solving all Issues and Deal Impediments

3. Be Prepared

4. Control Client and Attorney

5. Set Schedule

6. Research Market Outside of Your Deals

7. Keep Attitude Upbeat and Expedient

8. Befriend Adversaries

[LISTING BROKER COMPANY LETTERHEAD]

[DATE]

[BROKER'S NAME AND ADDRESS]

Re: Proposal for Lease by **[NAME OF TENANT]** in building located at **[ADDRESS]**, which Building is part of the office project known as "**[NAME OF PROJECT]**."

Dear _____:

_____ on behalf of _____ ("**Landlord**"), is pleased to submit a lease proposal for **[NAME OF TENANT]** ("**Tenant**") to lease space in the referenced Building on the terms and conditions set forth as follows. This proposal is submitted in order to permit the parties to engage in open and informed discussions of potential leasing terms, and is not intended as and shall not constitute an offer, an acceptance or a contract.

1. BUILDING. Office building located at _____ _____.

2. PROJECT DESCRIPTION. **[TO BE COMPLETED]**

_____
_____
_____
_____

3. PREMISES.

Floor(s)	Approximate Square Feet
[INSERT APPROPRIATE FIGURES]	

OPTIONAL PROVISIONS RELATING TO THE EXPANSION OF THE PREMISES:

3.1 PRE-MOVE-IN EXPANSION OPTION. Tenant shall have the right, up until _____, to lease approximately _____ rentable square feet on the _____ (_____) floor of the Building under the same terms and conditions as those set forth herein

for the initial Premises, subject only to the determination by Landlord of base rent and revised dates for submission of construction drawings by Tenant relating to such space.

3.2 MUST-TAKE SPACE. Tenant shall lease _____ rentable square feet of space on the ____ floor of the Building during _____. The exact amount of and delivery date of such space shall be determined by Landlord in its discretion. The leasing of such space shall be on the same terms and conditions as are then applicable to the initial Premises **[THIS APPROACH COULD BE CHANGED]**; provided that if such space has been previously improved, Tenant shall take such space in its "as is" condition, and if such space has not been previously improved, Tenant shall receive an improvement allowance equal to _____. **[IN ADDITION TO THE FOREGOING HANDLING OF A TENANT IMPROVEMENT ALLOWANCE, A SPECIFIC ALLOWANCE COULD BE AGREED UPON WHICH WOULD BE OFFSET BY THE THIRD-PARTY VALUE OF ANY EXISTING IMPROVEMENTS]** .

3.3 OPTIONS FOR ADDITIONAL SPACE. Tenant shall have the right to lease additional space ("**Option Space**") in the Building. The location and scheduled delivery dates for each increment of Option Space and the range of square footages for each such increment are as follows:

Square Footage	Floor	Delivery Date

[INSERT APPROPRIATE FIGURES]

Tenant shall give Landlord _____ (___) months' written notice of its intention to exercise each option prior to the scheduled delivery date.

Landlord shall deliver the Option Space up to _____ (__) months prior or _____ (__) months following the scheduled delivery date at Landlord's discretion.

Terms and conditions for such Option Space shall be the terms and conditions being quoted by Landlord for comparable space in the Building as of the date of the commencement of the respective option, but in no event shall the annual base rent for the Option Space be less than the then current Annual Base Rent, plus escalations, for the Premises. The rights granted to Tenant hereunder are personal to Tenant and may only be exercised by Tenant when Tenant is in possession of the entire Premises.

3.4 RIGHT OF FIRST OFFER. **[ONE-TIME TENANT TRIGGERING RIGHT]** During the Lease Term, Tenant may give a written notice to Landlord which sets forth that Tenant desires to lease additional space in the Building. During the six (6) month period following Landlord's receipt of such notice, Landlord shall grant to Tenant a one-time right of first offer, following initial leasing, on all remaining space on the _____ (_____) floor of the Building. The terms and conditions for the lease of such space shall be those then being quoted by Landlord for the leasing of comparable space in the Building, but in no event shall the annual base rent for such space be less than the then current Annual Base Rent, plus escalations, for the Premises. Tenant must elect to lease such space within five (5) business days of Landlord's offer to lease such space. If Tenant does not timely elect to lease such space, Landlord may lease such space to anyone whom Landlord desires upon terms acceptable to Landlord. The rights granted to Tenant hereunder are personal to Tenant and may only be exercised by Tenant when Tenant is in possession of the entire Premises.

OR

[STACKING TENANT TRIGGERED RIGHT] Tenant may, once during any calendar year during the Lease Term, deliver to Landlord a written notice requesting whether

or not any space on the _____ (_____) floor of the Building will, during the following six (6) month period, become available for rental, and whether any tenants with rights superior to those of Tenant have a superior option on such space. Within ten (10) business days of its receipt of such notice, Landlord shall so inform Tenant in writing. In the event any such space does (or will) exist, such notice shall give Tenant a right of first offer on such space. The terms and conditions for the lease of such space shall be those then being quoted by Landlord for the leasing of comparable space in the Building, but in no event shall the annual base rent for such space be less than the then current Annual Base Rent, plus escalations, for the Premises. Tenant must elect to lease such space within five (5) business days of Landlord's offer to lease such space. If Tenant does not timely elect to lease such space, Landlord may lease such space to anyone whom Landlord desires upon terms acceptable to Landlord. The rights granted to Tenant hereunder are personal to Tenant and may only be exercised by Tenant when Tenant is in possession of the entire Premises.

3.5 RIGHT OF FIRST NEGOTIATE.

Tenant may, once during any calendar year during the Lease Term, deliver to Landlord a written notice requesting whether or not any space on the _____ (_____) floor of the Building will, during the following six (6) month period, become available for rental, and whether any tenants with rights superior to those of Tenant have a superior option on such space. Within ten (10) business days of its receipt of such notice, Landlord shall so inform Tenant in writing. In the event any such space does (or will) exist, Landlord shall notify Tenant of its intent to lease such space and Tenant shall have five (5) business days to commence good faith negotiations with Landlord concerning such space. If Tenant does not timely elect to negotiate with Landlord to lease such space, Landlord may lease such space to anyone whom Landlord desires upon terms acceptable to Landlord.

The rights granted to Tenant hereunder are personal to Tenant and may only be exercised by Tenant when Tenant is in possession of the entire Premises.

4. METHOD OF MEASUREMENT **[SEE OPTIONAL NEGOTIATED PROVISION]**.

For purposes of this Lease, "**rentable square feet"** and **"usable square feet"** of the Premises shall be deemed as set forth in the Lease and the rentable square feet of the Building shall be deemed as set forth in the Lease.

[OPTIONAL: "Rentable square feet" and "usable square feet" shall be calculated pursuant to Standard Method of Measuring Floor Area in Office Building, ANSI Z65.1 - 1996 ("**BOMA**"). Within thirty (30) days after the Lease Commencement Date, Landlord's space planner/architect shall measure the rentable and usable square feet of the Premises. The determination of Landlord's space planner/architect shall be conclusive and binding upon the parties. In the event that Landlord's space planner/architect determines that the amounts thereof shall be different from those set forth in the Lease, all amounts, percentages and figures appearing or referred to in the Lease based upon such incorrect amount shall be modified in accordance with such determination.**]**

5. PURPOSE OF USE**.**

The Premises will be used for business and professional offices in keeping with the character of a first class office building.

6. LEASE TERM.

The term of the Lease (the "**Lease Term**") shall be **[INSERT TERM]** years.

The Lease Term shall commence: **[THE FOLLOWING NEEDS TO BE COORDINATED WITH THE BENEFICIAL OCCUPANCY PROVISIONS IN SECTION 8 OF THIS PROPOSAL BELOW]**

[**FOR USE WITH A TENANT BUILD** - The "**Lease Commencement Date**" shall be the date which is **[INSERT CUMULATIVE BUILD-OUT PERIOD AND BENEFICIAL OCCUPANCY PERIOD, IF ANY]** _____ (___) days after the delivery of the Premises to Tenant for the start of Tenant's construction of the tenant improvements (the "**Delivery Date**"), which Delivery Date is anticipated to be _____, 200__.]

[**FOR USE WITH A LANDLORD BUILD** - The "Lease Commencement Date" shall be the date which is **[INSERT BENEFICIAL OCCUPANCY PERIOD, IF ANY]** _____ (___) days after the date upon which the Premises are substantially completed ("**Ready for Occupancy**"), which is anticipated to be _____, 200__.]

OPTIONAL PROVISIONS RELATING TO THE EXTENSION OR TERMINATION OF THE LEASE TERM.

6.1 OPTION TO RENEW. Tenant shall have _____ (_____) five (5) year option(s) to renew all space then under lease by Tenant, upon first providing Landlord with eighteen (18) months' prior written notice. The annual base rent for an option term shall be the "Fair Market Rent," the calculation of which shall be more particularly set forth in the Lease, for comparable space in the Building as of the date of the commencement of such option, but in no event shall the annual base rent be less than the Annual Base Rent, plus escalations, paid by Tenant at the expiration of the then current Lease Term. The rights granted to Tenant hereunder are personal to Tenant and may only be exercised by Tenant when Tenant is in possession of the entire Premises.

6.2 TENANT LEASE CANCELLATION OPTION UPON PAYMENT OF A TERMINATION FEE **[SEE** Tenant shall have a one-time right to cancel the lease effective at the end of the ____ month of the initial Lease Term (the "**Termination Date**"). Tenant must give notice of its

CALCULATION OF TERMINATION FEE].

intention to cancel the lease not later than one-year prior to the Termination Date. In the event Tenant exercises its option to cancel, Tenant shall, at the time of such exercise, pay Landlord a cancellation fee equal to **[THE AMOUNT OF THE TERMINATION FEE CAN BE CALCULATED AT THE LEASE PROPOSAL STAGE AS FOLLOWS:** the outstanding principal balance as of the Termination Date of a loan, payable in equal monthly installments, with (i) an original principal balance equal to the sum of the tenant improvement allowance, any free rent, and any brokerage commissions payable by Landlord in connection with the Lease, (ii) assuming a **[FILL IN PROPER INTEREST RATE]** annual interest factor, and (iii) a period of amortization equal to the total number of months of the Lease Term occurring after the expiration of any free rent period. The Cancellation Fee will be increased by the same formula if Tenant leases any expansion, must-take, or right of first offer space. The rights granted to Tenant hereunder are personal to Tenant and may only be exercised by Tenant when Tenant is in possession of the entire Premises.

6.3 TENANT CANCELLATION OPTION UPON FAILURE OF LANDLORD TO TIMELY COMPLETE THE PREMISES.

Landlord shall use diligent efforts to cause the completion of Tenant's space to occur on or before **[INSERT A DATE PREFERABLY ONE YEAR LATER THAN THE ANTICIPATED LEASE COMMENCE-MENT DATE]** (the "**Outside Date**"). In the event the delivery of the Premises is delayed beyond the Outside Date, and such delay is not caused by Tenant or by force majeure, then Tenant's sole right shall be a five (5) business day right to terminate the lease by written notice to Landlord. Notwithstanding the above, Landlord shall have the one-time right to extend the Outside Date for thirty (30) days by delivering to Tenant a certificate from Landlord that in Landlord's best good faith judgment the substantial completion of Tenant's space will occur within thirty (30) days after the Outside Date. In addition, if, at

any time, Landlord determines that Landlord will be unable to deliver the Premises by the Outside Date, Landlord may notify Tenant of Landlord's good faith opinion, as to when the Premises will be delivered, and within five (5) business days thereafter, Tenant must notify Landlord as to whether Tenant will (i) terminate the Lease or (ii) agree to extend the Outside Date to the date set forth in Landlord's notice.

7. ANNUAL BASE RENT. The annual base rent (the "**Annual Base Rent**") per rentable square foot of the initial Premises during the Lease Term shall be as follows:

Year(s)	Floor(s)	Annual Base Rent

[INSERT APPROPRIATE FIGURES]

8. BENEFICIAL OCCUPANCY PERIOD. **[USE ONLY IF GRANTING A BENEFICIAL OCCUPANCY PERIOD -** Concurrently with the execution of the Lease, Landlord and Tenant shall enter into a beneficial occupancy side letter agreement, which letter shall provide for the application of terms of the Lease, excepting only the payment of Base Rent, during such beneficial occupancy period. Tenant shall pay its full share of operating expenses and real property taxes attributable to such period of time.

9. PROPERTY TAX AND OPERATING EXPENSE ADJUSTMENTS **[SEE ALTERNATIVE PROVISIONS OF "EXPENSE STOP" VERSUS "BASE YEAR" SCENARIOS VERSUS RETAIL "N/N/N" SCENARIO]**. **[EXPENSE STOP** - If, during the Lease Term, Tenant's proportionate share of taxes and operating expenses for the Building exceeds **[INSERT EXPENSE STOP]** per rentable square foot of the Premises, Tenant shall be responsible for such excess. Operating expenses will be calculated on a grossed-up basis reflecting variable operating expenses as if the Building was fully occupied.**]**

OR

[BASE YEAR - If, during the Lease Term, Tenant's proportionate share of taxes and

operating expenses for the Building exceeds the amount of operating expenses and taxes for **[INSERT BASE YEAR]**, Tenant shall be responsible for such excess. Operating expenses will be calculated on a grossed-up basis reflecting variable operating expenses as if the Building was 95% occupied. Real property taxes will be calculated as if the Building and parking structure were fully completed and fully occupied. Notwithstanding anything to the contrary set forth herein, Landlord may elect, at anytime during the Lease Term, to exclude from such Operation Expenses the cost of electricity to the Premises for which Tenant shall, upon such election, directly pay; provided, however, an appropriate reduction is made to the Base Year Operating Expenses to account for such modification.**]**

OR

[N/N/N - During the Lease Term, Tenant shall pay its proportionate share of taxes and operating expenses for the Building. Operating expenses will be calculated on a grossed-up basis reflecting variable operating expenses as if the Building was fully occupied].

[OPTIONAL PROVISIONS - Tenant shall, at its expense, directly meter the Premises for water, gas, and electrical usage, and Tenant shall pay directly for such utilities].

OPTIONAL PROPOSITION 13 PROTECTION AND PROPOSITION 13 PROTECTION BUY-OUT PROVISIONS:

[PROPOSITION 13 PROTECTION SHOULD ONLY BE INCLUDED FOLLOWING EXTENSIVE INTERNAL (LANDLORD) DISCUSSIONS AND AGREEMENT]

9.1 TOTAL PROPOSITION 13 PROTECTION.

If during the **[INSERT NUMBER OF YEARS OF TOTAL PROPOSITION 13 PROTECTION]** years of the Lease Term, a sale or refinancing of the Building is consummated, and as a result thereof, the real property taxes for the Building increase pursuant to a reassessment under the terms of

Proposition 13, then Tenant shall not be obligated to pay, during the **[INSERT NUMBER OF YEARS OF TOTAL PROPOSITION 13 PROTECTION]** years of the Lease Term, any portion of such increase.

9.2 TOTAL AND PARTIAL PROPOSITION 13 PROTECTION.

If during the **[INSERT NUMBER OF YEARS OF TOTAL PROPOSITION 13 PROTECTION]** years of the Lease Term, a sale or refinancing of the Building is consummated, and as a result thereof, the real property taxes for the Building increase pursuant to a reassessment (the "**Reassessment**") under the terms of Proposition 13, then Tenant shall not be obligated to pay, during the **[INSERT NUMBER OF YEARS OF TOTAL PROPOSITION 13 PROTECTION]** years of the Lease Term, any portion of such increase (the "**Tax Increase**"). For each year occurring after the **[INSERT LAST YEAR OF TOTAL PROPOSITION 13 PROTECTION]** year of the Lease Term, Tenant shall pay an annually increasing percentage of its share of the Tax Increase, which percentage is calculated by compounding ten percent (10%), on a cumulative basis, for each year of the Lease Term which has occurred up to and including the year of the Reassessment.

9.3 EXAMPLE OF APPLICATION OF FIVE-YEAR TOTAL PROTECTION AND FIVE-YEAR PARTIAL PROTECTION.

As an illustration of the application of the terms of this provision, assume that the Building is initially fully assessed for real estate tax purposes at an amount equal to $3.00 per rentable square foot of the Building, and immediately thereafter, on the first day of the second year of the Lease Term, the Building is sold and on such day the Building is reassessed so that the real estate taxes are increased to an amount equal to $5.00 per rentable square foot of the Building. For the first five years of the Lease Term, Tenant would not pay any portion of the $2.00 tax increase attributable to such reassessment ($5.00 - $3.00). Commencing in the sixth year of the Lease Term and until the end of the Lease Term, Tenant would pay an increasing percentage of such $2.00 tax

increase as follows: (i) sixth year - 77.16%, (ii) seventh year - 94.87%, and (iii) eighth through tenth years - 100%.

9.4 LANDLORD'S PROPOSITION 13 BUY-OUT OPTION

Notwithstanding anything to the contrary set forth above, Landlord shall have the right to accelerate the foregoing Proposition 13 protection, and thereby eliminate the same, at any given time by paying Tenant the present value of the then-remaining Proposition 13 protection, which present value shall be calculated by using a rate equal to the floating commercial loan rate announced from time to time by Bank of America, a national banking association, or its successor, as its prime rate plus two percent (2.0%) per annum, which prime rates shall be those in effect for the above time periods at such time as Landlord exercises its right to accelerate.

10. ASSIGNMENT AND SUBLEASING **[SEE NEGOTIATED RECAPTURE PROVISION]**.

Tenant shall have the right during the Lease Term to sublease or assign all or any portion of the Premises to a related entity or affiliate (as defined in Landlord's lease form) upon notification to Landlord. In addition, Tenant shall have the right to assign or sublease to unrelated entities as provided below. Tenant shall remain liable to Landlord for performance under the Lease regardless of such sublease or assignment.

In addition, Tenant shall have the right to assign or sublease all or any portion of the Premises subject to Landlord's consent, which consent will not be unreasonably withheld or delayed. Landlord shall retain _____ percent (___%) of all profits paid in connection with any sublease or assignment in excess of Tenant's rent obligations hereunder.

Upon Tenant's notice to Landlord of an intended sublease or assignment of all or any portion of the Premises, Landlord shall have the right to recapture such sublease or assignment space (except to any related entity or affiliate of Tenant). **[ALTERNATE NEGOTIATED RECAPTURE**

PROVISION - If Tenant intends to sublease or assign all or any portion of the Premises, Tenant shall give Landlord notice of such intention, and Landlord may, within ninety (90) days of such notice, recapture the portion of the Premises pertaining to the intended assignment or sublease for the term of such intended sublease or assignment].

11. CONSTRUCTION OF TENANT IMPROVEMENTS **[SEE ALTERNATIVE PROVISIONS FOR LANDLORD CONTROLLED CONSTRUCTION WITH "ALLOWANCE" VERSUS "TURN-KEY" SCENARIOS AND "TENANT CONTROLLED CONSTRUCTION WITH ALLOWANCE"].**

[LANDLORD CONTROLLED CONSTRUCTION\ ALLOWANCE - Landlord shall provide Tenant an allowance of $_____ per rentable square foot of Premises to be used by Tenant for permanently affixed improvements and the cost of all architecture and engineering fees, licenses and permits for the construction of the Premises].

OR

[LANDLORD CONTROLLED CONSTRUCTION\ TURN-KEY Landlord shall construct the Premises according to **[INSERT PLANS AND SPECIFICATIONS]**, but in no event shall Landlord's contribution to the cost of the construction of the Premises exceed $_____ per usable of the Premises.

Tenant shall select an interior architect of its choice who shall prepare Final Space Plans for the entire Premises by _____, 199__. Tenant shall submit drawings, specifications, quantities and purchase releases for all long-lead items and for all structural and internal stairway items and requirements to be used in connection with the construction of the tenant improvements by _____, 199__. Tenant shall submit Final Working Drawings to Landlord on or before _____, 199__. Landlord shall construct the improvements and shall be paid a construction supervisory fee by Tenant of **[INSERT FEE]** the total cost of such design and construction. **[USE THIS PROVISION WITH BOTH LANDLORD CONTROLLED CONSTRUCTION**

SCENARIOS AND IN ORDER TO EXPEDITE THE DESIGN PROCESS DURING LEASE NEGOTIATIONS].

OR

[TENANT CONTROLLED CONSTRUCTION WITH ALLOWANCE - Landlord shall provide Tenant an allowance of $_____ per usable square foot of the Premises to be used by Tenant to construct the Premises. Tenant shall retain a contractor selected from a list of contractor approved by Landlord to construct the Premises. Tenant shall pay Landlord a construction coordination fee of **[INSERT FEE]** of the total cost of the design and construction of the Premises].

12. PARKING. Tenant shall rent parking passes in the Building parking areas at a ratio of **[INSERT RATIO]** ____ (__) parking passes per one thousand (1,000) rentable space square feet of the Premises. Initial parking rates will be **[INSERT PARKING RATE]** per space per month. Thereafter, the parking rates shall be increased (on an annual basis) to the then prevailing rate charged from time to time at the location of such parking passes.

[OPTIONAL REQUIREMENT:] Tenant shall observe, and shall cause its employees and invitees to observe, the terms of the CC&R's which affect the Building.

13. HEATING, VENTILATION AND AIR-CONDITIONING **[SEE OPTIONAL PROVISION]**.Landlord, as part of operating expenses, shall furnish heating, ventilation and air-conditioning for normal office usage, Monday through Friday, from _____ a.m. to _____ p.m., and Saturday, from _____ a.m. to _____ p.m., except for recognized national and state holidays. **[OPTIONAL** - Landlord shall provide, upon Tenant's request and at Tenant's expense, after-hours heating, ventilation and air conditioning on an hourly, full-floor basis under terms and conditions to be established by Landlord].

14.	ELECTRICITY.	Landlord, as part of operating expenses, shall provide Tenant with electricity for lighting and normal office equipment to the extent such electrical consumption does not exceed four (4) watts per rentable square foot of the Premises. To the extent such electrical consumption exceeds four (4) watts per rentable square foot of the Premises, Tenant shall directly pay for such excess use, or, at Landlord's option, Landlord may make an equitable determination of the cost of such excess which Tenant shall pay immediately upon such determination by Landlord.
15.	CLEANING SPECIFICATIONS.	Landlord, as part of operating expenses, will clean Tenant's premises five (5) days per week.
16.	IDENTITY.	Tenant shall be permitted to install, at its expense and subject to Landlord's consent which will not be unreasonably withheld, signage at the entrance of its premises on any full floor that it occupies. Signage on multi-tenant floors will be according to Building standard.
17.	DIRECTORY BOARD.	Landlord, at Landlord's expense, will furnish Tenant with space on the Building directory for ____ (___) designated names per each one thousand (1,000) rentable square feet of the Premises.
18.	BUILDING MANAGEMENT.	The managing agent of the Building shall operate the Building in a first class manner.
19.	BUILDING SECURITY.	Landlord, at Landlord's expense (to be included as an operating expense), shall provide Building access control systems and procedures. Tenant, at its own cost and with Landlord's consent, shall be permitted to install its own security system for the Premises.
20.	SECURITY REQUIREMENTS **[SEE ALTERNATE PROVISIONS]**.	[Tenant shall pay a security deposit equal to _____ (____) months' Annual Base Rent (calculated as of the ____ month of the Lease Term) upon execution of the Lease.] AND\OR

[Tenant shall deliver to Landlord an unconditional, clean, irrevocable letter of credit in an [initial] amount equal to $_____, upon execution of the Lease. Such letter of credit shall be issued by a money-center bank (a bank which accepts deposits, maintains accounts, has a local [Los Angeles/San Francisco] office which will negotiate a letter of credit, and whose deposits are insured by the FDIC) reasonably acceptable to Landlord, and which letter of credit shall be in the form to be attached to the Lease. Tenant shall pay all expenses, points and/or fees incurred by Tenant in obtaining the letter of intent.] [**A LETTER OF CREDIT BURN DOWN MAY BE FASHIONED WHEREBY, UPON EITHER THE PASSAGE OF TIME OR THE MAINTENANCE OF CERTAIN FINANCIAL BENCHMARKS FOR A PERIOD, THE AMOUNT OF THE LETTER OF CREDIT MAY BE REDUCED AND/OR ELIMINATED**]

AND\OR

[Appropriate guarantees shall be determined upon Landlord's review of Tenant's financial information.]

AND\OR

[The obligations of Tenant under the Lease shall be personally guaranteed by the principals of the firm.]

AND\OR

[It is understood and agreed that the partners of Tenant shall be personally jointly and severally liable for any claim arising out of or relating to the Lease.]

OPTIONAL MISCELLANEOUS PROVISIONS:

21. RELOCATION ALLOWANCE. Landlord will provide Tenant up to $____ per usable square foot of the Premises for the cost

of Tenant's relocation to the Premises. Such relocation costs are subject to Landlord's approval, which shall not be unreasonably withheld.

22. NON-DISTURBANCE AGREEMENT. Landlord shall use good faith efforts to secure and deliver to Tenant a non-disturbance agreement executed by the first trust deed holder of the Building.

23. BUILDING PLANNING. Upon notice to Tenant, Landlord may relocate the Premises to other space in the Building.

24. **[OPTIONAL PROVISION TO BE USED WHERE BUILDING/PROJECT SUBJECT TO AN REA OR CC&Rs]** CC&Rs **[MODIFY, AS NECESSARY, WITH REGARD TO AN REA]** Tenant shall comply with all recorded covenants, conditions, and restrictions currently affecting the Project and future covenants, conditions, and restrictions (the "**CC&Rs**") which Landlord, in Landlord's discretion, deems reasonably necessary or desirable, and Tenant shall agree that the Lease shall be subject and subordinate to such CC&Rs.

25. RIGHT OF FIRST NEGOTIATION TO PURCHASE THE PREMISES. The Lease shall provide that Landlord shall grants to the Original Tenant a right of first negotiation to purchase the Premises on the terms and conditions set forth in this Paragraph 25.

(a) Procedure. If, at the time that Landlord determines that it will commence to market the entire Premises for sale to a third-party, not affiliated with Landlord in any manner and not as part of any financing of the Project, Tenant is leasing and directly occupying over fifty percent (50%) of the rentable square footage of the Premises (provided that such occupancy requirement shall not apply prior to the Lease Commencement Date), then, prior to commencing to actively market the Premises for sale (whether prior to, on or after the Lease Commencement Date), Landlord shall notify Tenant of such determination (the "Notice of Sale"). If, within five (5) business days after Landlord's delivery of such notice to Tenant, Tenant notifies Landlord (the "Purchase

Interest Notice") that it is interested in purchasing the Premises, then, prior to Landlord commencing to actively market the Premises for sale, Landlord shall meet exclusively with Tenant and discuss in good faith terms and conditions of a potential sale of the Premises to Tenant. If Landlord and Tenant do not reach agreement as to the material economic terms of such a sale of the Premises to Tenant within sixty (60) days, or if Tenant earlier indicates to Landlord that it is not interested in further discussions, then Landlord, in its sole and absolute discretion, shall have the right to terminate its exclusive negotiations with Tenant and to sell the Premises to anyone whom Landlord desires on any terms which Landlord desires, in Landlord's sole discretion.

(b) Termination of Right of First Negotiation. The rights contained in the Lease provisions pertaining to such Right of First Negotiation shall be personal to Original Tenant, and may only be exercised by Original Tenant and its Affiliates, and not by any assignee, sublessee or other "Transferee," as that term shall be defined in the Lease, of Tenant's interest in this Lease. Tenant shall not have the rights provided in this Paragraph 25, if, as of the date of the attempted exercise of such right, Tenant is in Material Default under the Lease.

[STANDARD OPTION: This lease proposal is intended as an outline of the major lease provisions only and, whether or not countersigned, is not a binding agreement by either party to lease the Premises. As a result, notwithstanding the execution of this lease proposal by Landlord and Tenant, neither Landlord nor Tenant shall have any legal obligation or liability to the other with respect to the matters set forth in this lease proposal unless and until a mutually agreed upon lease document is fully executed and delivered by both parties. As such, the parties hereby acknowledge and agree that this lease proposal is nonbinding and that any acts or omissions undertaken or any costs or expenses incurred by Landlord or Tenant following the execution of this lease proposal are made or incurred at such party's sole risk and expense. Tenant hereby acknowledges that the execution of this lease proposal by Landlord does not in any way prohibit or limit Landlord's right to market the Premises or a portion thereof or to negotiate and/or consummate a lease transaction with third parties with respect to all or a portion of the Premises. This lease proposal contains all of the agreements of the parties hereto with respect to any matter

covered or mentioned in this lease proposal, and no prior agreements or understanding pertaining to any such matters shall be effective for any purpose.**]**

OR

[THE FOLLOWING SHOULD ONLY BE USED UPON EXTENSIVE REVIEW AND AGREEMENT OF INTERNAL LANDLORD PERSONNEL] [Non-Binding. Tenant and Landlord agree that the terms set forth herein are intended merely as an outline for negotiation of a potential purchase and sale transaction to be documented by formal written agreement, and only reflect our present understanding of the discussions we have had regarding the terms and conditions of the proposed transaction. Tenant and Landlord agree that in no event does this Letter constitute a formal or binding agreement and that the provisions hereof are not binding on either party. Upon Landlord's receipt of a copy of this Letter signed by Tenant, Landlord will arrange for its counsel to prepare an Agreement of Purchase and Sale and Joint Escrow Instructions (the "Purchase Agreement") reflecting the terms and conditions contained herein. The legal rights and obligations of Tenant and Landlord shall be only those which are set forth in such definitive Purchase Agreement when and if executed and delivered by both Tenant and Landlord. Notwithstanding any provision to the contrary contained herein, this Letter shall not constitute an agreement to negotiate and solely constitutes an outline of the terms of negotiation. Tenant and Landlord each acknowledge and agree that each party is proceeding with negotiations related to the proposed transaction at its sole cost and expense (which may involve substantial transaction costs) and that either party may terminate negotiations for any reason, at any time, without any liability or obligation whatsoever.**]**

The undersigned acknowledges that all correspondence (including this lease proposal) and all communication between Landlord, Tenant, and the undersigned concerning information which may ultimately become or becomes part of the Lease is confidential information (collectively, the "**Confidential Information**"). Whether or not the Lease is ultimately consummated, the undersigned and Tenant shall keep the Confidential Information strictly confidential and shall not disclose the Confidential Information to any person or entity other than Tenant's financial, legal, and space planning consultants.

Please return a signed counterpart of this letter by no later than **[DATE]** to confirm your concurrence with the noncontractual terms outlined here.

Sincerely,

"**[LISTING BROKER COMPANY]**"

By:_____

Its:_____

"TENANT"

By:_____

Its:_____

Non-Disturbance Agreements for Subtenants;

Approaching the Master Landlord and Lender

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1. Overview.

(A) Traditional Non-Disturbance Agreements.

Whenever a tenant leases space, it runs the risk that it might lose its estate in the event that its landlord defaults under a senior mortgage agreement. The tenant's interest could be extinguished either by reason of the foreclosure of an encumbrance in existence at the time that the parties executed the lease, or even – if the lease includes a subordination clause – by reason of the foreclosure of an encumbrance created after the execution of the lease. A tenant should therefore generally attempt to protect its leasehold interest by entering into a non-disturbance agreement with the mortgagee, concurrently with the execution of the lease. Under such a non-disturbance agreement (often referred to as a recognition agreement), a "mortgagee covenants that, in the event of a foreclosure, the tenant will remain on the leased premises so long as the tenant continues to comply with the terms of the lease and the lease is not in default." (*See* Feinstein & Keyles, *Foreclosure: Subordination, Non-Disturbance and Attornment Agreements* (Aug. 1989) Prob. & Property, 38, 39, cited in *Miscione v. Barton Development Company* (1997) 52 Cal.App.4th 1320, 1327). In fact, "the concept of non-disturbance is frequently intended to refer not only to non-disturbance of the tenant's right of possession, but also to full recognition of all of the tenant's rights under its lease." (*See* Fisher & Goldman, *The Ritual Dance Between Lessee and Lender* (Fall 1995) 30 Real Property, Prob. & Trust J. 355, 357, cited in *Miscione*, 52 Cal.App.4th at 1327).

Traditionally, it has principally been major credit tenants who have been able to obtain such non-disturbance agreements, either in the form of a separate agreement or of a provision in the lease. The non-disturbance agreement assures them that they will be able to retain possession of the leased premises in the event that the landlord-mortgagor's equity of redemption is foreclosed and that their landlord loses title to the mortgaged property. In return for such an agreement, of course, the lender will often insist that the tenant agree to attorn to the lender in the event of the mortgagor's default. Under an attornment clause, a "tenant covenants with the mortgagee that, in the event of foreclosure, the lease will not be extinguished but will continue as a lease between the mortgagee (or any successor to it) and the tenant . . . [; t]he tenant, in other words, agrees to recognize that another party who would not otherwise have privity may enforce the lease agreement as though the third party were originally a beneficiary of the agreement."

(*See* Feinstein & Keyles at 39, cited in *Miscione*, 52 Cal.App.4th at 1327-1328). The parties may also enter into a subordination agreement, whereby "one holding an otherwise senior lien or other real estate interest consents to a reduction in priority *vis-à-vis* another person holding an interest in the same real estate." (*See* Black's Law Dict. (6th ed. 1990) p. 1426, col. 2, cited in *Miscione*, 52 Cal.App.4th at 1327.) Such a subordination clause or agreement will typically provide for the subordination of the tenant's interest to that of any subsequent mortgagee.

A non-disturbance agreement is of particular importance to a tenant, insofar as it will protect the tenant from the considerable expense and inconvenience of being summarily ousted from the leased premises in the event of foreclosure of the landlord-mortgagor's equity of redemption. Of course, such an agreement will be all the more important from the tenant's standpoint if the tenant anticipates that market rental rates may rise over the course of the lease term: in such an event, the non-disturbance agreement not only protects the tenant's continued use and enjoyment of the leased space but protects the tenant's favorable current rental rate. Even if the tenant's negotiated rental rate proves not to be so favorable (as by reason of a collapse in the market rental rates), the non-disturbance agreement is desirable from the tenant's perspective insofar as it leaves him free (in the absence of an attornment agreement) to abandon the premises in the event of a foreclosure if it determines that it can secure a more favorable rate elsewhere.

(B) Subtenants' Reasons For Seeking a Non-Disturbance Agreement.

Tenants therefore have good reason to seek a non-disturbance agreement from their prospective landlords' mortgagees. But prospective subtenants have additional reasons to want such a recognition agreement. A subtenant must of course, for all the reasons discussed above, prepare for the eventuality that a termination of the master landlord's estate (by reason of a default under a mortgage agreement) might effect a termination of its estate. But in addition, any prospective subtenant must confront the possibility that, should it enter into a given sublease, its estate could be extinguished by a termination of the sublandlord's estate as well. The subtenant's estate could of course be terminated as a result of the sublandlord's breach under the master lease. *See Fifth and Broadway Partnership v. Kimny, Inc.* (1980) 102 Cal.App.3d 195, 201. And in the event of the direct tenant's bankruptcy, its rejection of the master lease under § 365 of the Bankruptcy Code would constitute a breach as well. *See, e.g.,* Bankruptcy Code, 11 U.S.C.A., § 365(g); *In re Austin Development Company* (5th Cir. 1994) 19 F.3d 1077, 1082. In the Ninth Circuit, such a breach would effect an actual termination of the rejected lease, permitting the bankruptcy court to compel immediate surrender of the leased premises by the trustee and by any third parties claiming through the debtor. *See, e.g., In re McSheridan* (9th Cir.BAP 1995) 184 B.R. 91, 102; *George v. County of San Luis Obispo* (2000) 78 Cal.App.4th 1048, 1053. Finally, in some jurisdictions, the subtenant runs the risk that its leasehold interest might be jeopardized in the event that the sublandlord *voluntarily* abandoned the Premises; in California, however, a tenant's voluntary surrender of the leased premises to the master lessor will generally not destroy the subtenant's estate: *see Chumash Hill Properties, Inc. v. Peram* (1995) 39 Cal.App.4th 1226, 1233, *citing Buttner v. Kasser* (1912) 19 Cal.App. 755, 760.

In sum, subtenants have particular incentives to seek non-disturbance (recognition) agreements. Not only do they typically want to be able to preserve their estate in the event that the master landlord defaults on its mortgage agreement, but they also want protection in the

event that the sublandlord defaults on the master lease and its estate is involuntarily terminated, and in some states at least, in the event that the sublandlord voluntarily abandons the Premises. In other words, a prospective sublessee has reason to want two separate forms of non-disturbance agreement: (i) a non-disturbance agreement from the master landlord's mortgagee, and (ii) a non-disturbance agreement from the master landlord, preferably one that provides protection even in the event of the sublandlord's voluntary surrender of the premises.

2. Landlords' and Lenders' Incentives to Grant Non-Disturbance Agreements to Subtenants.

The question is whether the subtenant will have sufficient leverage to obtain such concessions from either party. In fact, prospective subtenants have had increasing success in obtaining such concessions from master landlords and their lenders. There are essentially two reasons for this increased willingness to engage in non-disturbance agreements. The first is that, until relatively recently, and in large part because of the decision of *Dover Mobile Estates v. Fiber Form Products* (1990) 220 Cal.App.3d 1494, many lenders suspected that attornment provisions would be unenforceable in the absence of a non-disturbance agreement. The second reason has to do with the fact that periods of economic downturn generate more subleasing activity. In the current economic cycle, landlords and their lenders are under considerable pressure from down-sizing tenants to accommodate their transfer requests and may therefore agree to accord non-disturbance rights to prospective subtenants, in order to retain their direct tenants at favorable rental rates. Both of these developments are discussed below.

(A) Enforceability of Attornment Clauses in the Absence of a Non-Disturbance Agreement.

(i) The *Dover* Case.

In the case of *Dover Mobile Estates*, the tenant-defendant had entered into a lease which included an explicit subordination clause, rendering the lease subordinate to any subsequent deeds of trust or mortgages. The lease did not, however, include a non-disturbance provision and does not appear (although the decision does not explicitly so state) to have included an attornment clause. The landlord later encumbered the property with a second deed of trust and ultimately defaulted. Some time after the foreclosure sale, having failed to come to an agreement with the foreclosure purchaser as to a proposed rent adjustment, the tenant surrendered the premises. When the foreclosure purchaser brought an action to recover rent, the former tenant asserted that the foreclosure sale had extinguished the lease by virtue of the subordination provision, and the court ruled for the defendant. In so ruling, the *Dover* court re-affirmed the general rule that a trustee's sale *automatically* terminates a junior lease (rather than giving the foreclosure purchaser the option of so terminating). When the tenant initially held over after the foreclosure sale, in attempting to negotiate a rent reduction with the new landlord, it therefore did so as a "tenant-at-sufferance," under the equivalent of a month-to-month tenancy, terminable by either party on thirty days' notice.

In reaching this conclusion, the court also recited, by way of dictum, that the tenant under such a subordinate lease could have obtained protection against automatic termination by requiring its landlord to obtain from the mortgagee a non-disturbance agreement in the tenant's

favor. In light of this comment, and in light of the repeated emphasis that the court had placed on the fact that a foreclosure sale automatically "extinguishes" a subordinate lease, many commentators interpreted the decision to have suggested that, in the absence of a non-disturbance clause, an attornment provision might not suffice to prevent extinguishment of the subordinate lease upon foreclosure sale. Mortgagees therefore had reason to fear that they might not be able to bind a subordinate tenant to a lease agreement in the event of foreclosure unless they agreed to extend a non-disturbance agreement in return for an attornment clause. This right – to bind the tenant to the lease in the event of foreclosure – would of course be particularly valuable to the lender in a depressed market, insofar as the mortgagee would be able to obtain a higher price at sale, and so would be more likely to recover its investment, with respect to a property that was generating steady income.

(ii) The *Miscione* and *Principal Mutual Life* Cases.

Two subsequent decisions have cast doubt on this interpretation, however, and appear to suggest that an attornment provision will be readily enforceable in the absence of a non-disturbance agreement. The *Miscione* case, *see supra*, involved, *inter alia*, an action for breach of an office lease which contained both an attornment clause and a subordination and non-disturbance clause. The case again involved the question whether a subordinate lease (and the tenants' obligations thereunder) would survive a foreclosure sale upon default of a senior encumbrance, and in this instance the court ruled for the successor landlord. The court distinguished *Dover* on the ground that the lease in that case had included no attornment provision and recited that in this case, "in contrast, the attornment clause fixed the rights of the parties after the foreclosure." *See Miscione*, 52 Cal.App.4th at 1329. The decision therefore provided at least some degree of comfort to lenders, insofar as it premised the survival of the lease specifically on the inclusion of the attornment clause, rather than on the combined inclusion of attornment and non-disturbance provisions. However, mortgagees still had some cause for concern insofar as a dissenting judge had contested the majority's differentiation of *Dover*, pointing out, quite rightly, that it was not at all clear from the text of that published opinion whether or not the lease in that case had included an attornment provision. The dissenting justice surmised that "it [was] more likely that there was an attornment clause in the *Dover* lease, but [that] the court did not discuss it because no one thought to give it the undue emphasis and strained construction given the attornment clause here." *See Miscione*, 52 Cal.App.4th at 1339.

Lenders could take comfort, however, in the subsequent decision of *Principal Mutual Life Insurance Company v. Vars, Pave, McCord & Freedman* (1998) 65 Cal.App.4th 1469, in which the Court of Appeal for the Second District reaffirmed the view that an attornment provision would cause a subordinate lease to survive a foreclosure sale, even in the absence of a non-disturbance agreement. In this case, the defendants had entered into a lease which included subordination and attornment clauses but which did *not* include a non-disturbance provision (*see Principal Mutual Life*, 65 Cal.App.4th at 1479), and were again deemed bound to the lease after foreclosure by virtue of the attornment provision. In this case, the facts were in fact somewhat more perilous from the lender's standpoint than those involved in *Miscione*. The attornment clause at issue differed from that involved in *Miscione* in that it did not automatically provide for the continued existence of the subordinated lease upon foreclosure but provided rather that upon request the tenant would enter into a *new* lease, incorporating the terms of the lease extinguished

by the foreclosure sale. The court nonetheless upheld the attornment clause by reference to the contract law doctrine of third-party beneficiaries, notwithstanding the fact that – in a sense – the clause had itself contemplated that the lease would be extinguished upon foreclosure sale. Most important, however, for our purposes is the fact that the court unequivocally vindicated the traditional view that an attornment clause will be enforceable even in the absence of a non-disturbance agreement. Alluding specifically to *Dover*, the majority stated as follows: "[n]or did *Dover* hold, as appellants suggest, that a non-disturbance clause is essential to the validity of an attornment provision." *See Principal Mutual Life*, 65 Cal.App.4th at 1483.

(iii) Conclusion From the Cases.

In sum, notwithstanding some initial confusion in the wake of the *Dover* decision, it now appears indisputable that attornment provisions should be readily enforceable in the absence of a non-disturbance agreement; and while all of these cases involved the specific issue of a tenant's attornment to a mortgagee (or to a foreclosure purchaser), there is no reason to doubt that the same result would obtain in the case of a subtenant. In other words, it appears that a subtenant could be readily compelled to attorn either to the master landlord or to the master landlord's mortgagee (or to a third-party foreclosure purchaser), regardless of whether such parties had consented to the execution of a non-disturbance agreement.

This begs the question: why should a master landlord or a mortgagee ever consent to the execution of a non-disturbance agreement, if a subtenant can be compelled to attorn in the absence of such an agreement?

(B) <u>Benefits to Landlords and Lenders of Extending Recognition to Subtenants</u>.

(i) Preventing Default by the Direct Tenant.

The answer is simply that it will often be in their interest to do so. In periods of economic slow-down, tenants tend to downsize and therefore come under pressure to sublease some of their excess space. And with the increase in vacancies and in subleasing activity that typically accompanies such an economic slow-down, tenants may not be able to attract prospective sublessees or to consummate sublease negotiations unless they agree to co-operate in obtaining recognition agreements from their landlords and their landlords' mortgagees. The danger, from the standpoint of landlord and lender, is that if such a down-sizing tenant fails to secure a subtenancy for its unwanted space, it may no longer be able to afford (or may claim that it can no longer afford) to abide by its lease and may abandon the premises. The landlord (and its lender) would then be left with the unpleasant necessity (i) of attempting to re-let the space in a depressed, tenants' market, and/or (ii) of pursuing, at considerable cost and inconvenience, a possibly toothless judgment against the defaulting tenant, in which event the tenant would almost certainly claim that the abandonment had been triggered to some degree by the landlord's/lender's own intransigence in failing to consent to a recognition agreement with a prospective subtenant. In a period of increased subleasing activity, the landlord and its mortgagee therefore often stand to lose very little by agreeing to execute such a non-disturbance agreement on behalf of a prospective subtenant. Such a concession not only increases the landlord's chances of retaining its direct tenant at an above-market rate, but increases its chances

of recovering against such a direct tenant in court in the event that the tenant ultimately defaults under the lease agreement.

(ii) Benefits in the Event of Default by the Direct Tenant.

Granted, then, the conferral of a non-disturbance agreement tends to lessen the risk of default by the direct tenant, by permitting the tenant to salvage some value in its unneeded space. But what if the direct tenant nonetheless ultimately defaults anyway? It might not then appear to be in the landlord's or the lender's interest to be bound to such a subtenancy. For example, imagine that a commercial landlord refuses to execute such a recognition agreement, and that the direct tenant's proposed sublease nonetheless goes through. Imagine then that the direct tenant later defaults under the terms of its lease agreement. The landlord would then be free either to negotiate a direct lease with the prior subtenant (whose subtenancy would have been extinguished by virtue of the termination of the master lease) or to proceed to market the property to any other third party at the then current fair market rental value. But if the landlord had agreed to execute a non-disturbance agreement on behalf of the subtenant, it would be bound by the terms of the subtenancy, notwithstanding any increase in the current market rental rate and notwithstanding the fact that the perpetuation of the subtenancy might impair the marketability of any remaining space to third parties. The lender might have even greater reservations with respect to such an agreement, insofar as it could find itself bound to a below-market subtenancy *not only* in the event that the master lessor defaulted under the mortgage agreement *but also* in the event that the sub-lessor defaulted under the master lease.

And yet the fact remains that, at least in the current economic climate, it may be to the advantage of landlord and lender to agree to such a concession, even taking into account the possibility that the direct tenant might ultimately default. From the standpoint of the landlord, even in the event that the tenant/sublessor defaulted under the master lease, and that the sublessee was therefore entitled, by virtue of a recognition agreement, to remain in possession at a below market rental, the lower rental would nonetheless be likely to provide a rate of return substantially similar to that which the landlord could obtain from a new third-party tenant, after taking into account down time, commissions, landlord-financed alterations and other rental concessions, which expenses would be likely to be substantial in a tenants' market. And of course, in a down cycle, the landlord would in no way be assured that the market rental rate would exceed the subtenant's negotiated rent at the time of the tenant's default. In other words, the subtenant's "below market" rental rate might prove to be equivalent to or slightly in excess of any market rate prevailing at the time of termination of the master lease. By the same token, it may be to the lender's advantage in a depressed market for the subtenancy to survive the foreclosure of the mortgage or the termination of the master lease: in such a case, it is at least assured of a steady income stream which can be applied toward the mortgagor's loan payments (in the event of the termination of the master lease) or which would render the property more readily marketable in the event of foreclosure sale (in the event of the mortgagor's default under the mortgage agreement).

Of course, the master landlord's and the lender's primary incentive in granting such a recognition agreement to a prospective subtenant will generally have been to accommodate a tenant under a lucrative direct lease. This incentive will be particularly acute when the direct tenant is perceived to be in financial difficulty and when there is therefore perceived to be a

particularly great risk that it might default under the lease. To the extent, then, that the master landlord's and lender's main justification in granting such a recognition agreement to the subtenant is to help alleviate a perceived financial difficulty on the part of the direct tenant (and to help prevent its default under the direct lease), they should also anticipate the possibility of the direct tenant's future bankruptcy. They should, in other words, draft the non-disturbance agreement in such a way as to specifically address the parties' respective rights and obligations in the event that the bankrupt sublessor rejects the master lease under § 365 of the Bankruptcy Code. And again, the parties' interest may tend to converge: it may benefit both parties to have the non-disturbance agreement specifically extend not only to instances of involuntary termination of the master lease by reason of the direct tenant's default, but *also* to the direct tenant's rejection of the master lease in the course of a bankruptcy proceeding. In the event of the direct tenant's bankruptcy, the master lessor and lender might indeed prefer to automatically retain some level of guaranteed return on at least a portion of the leased space.

(iii) Additional Considerations.

Both the landlord and the mortgagee will be in a strong position to negotiate, in return for their execution of a recognition agreement, some form of automatic increase in the subtenant's rental obligations in the event that the recognition agreement is triggered by some event of default. The landlord would of course seek to have the increase go into effect upon termination of the master lease, while the lender would typically be concerned to have the increase go into effect either upon termination of the master lease or upon foreclosure of the mortgage. The lender and landlord might agree, for example, that the "non-disturbed" subtenant's rent should be increased to the then prevailing market rental rate, if such exceeds the subtenant's rental obligations as of the date of termination of the senior interest. The subtenant, for its part, would want to restrict any provision for automatic rent increase and might attempt to negotiate some form of adjustment whereby, in the event of termination of the master lease or of foreclosure of the mortgage, its Base Rent obligations would be set at the lower of the then prevailing market rental rate and the sublessor's "per square foot" rental rate, but (as an obvious concession by the subtenant) in no event lower than the subtenant's face sublease rate.

In addition, of course, the landlord and lender should confirm, before conceding to any form of recognition, that the subtenant's rights and obligations under the proposed sublease are reasonably similar to those accorded the direct tenant under the master lease. Likewise, insofar as any recognition agreement might ultimately entitle the proposed subtenant to retain possession as a direct tenant, the sublease agreement should generally not impose any burdens or obligations on the master landlord or its successors not contemplated under the master lease.

Finally, the master landlord and its mortgagee may want the proposed sublease (and/or the non-disturbance agreement) to specifically address the question of the parties' respective rights and obligations in the event of the direct tenant's bankruptcy. Indeed, for the reasons discussed above, it will often make sense for the parties to provide for recognition not only in the event of involuntary termination of the master lease by reason of the direct tenant's default but also in the event of the direct tenant's rejection of the master lease under § 365 of the Bankruptcy Code. The parties should also determine whether, under applicable state law, the subtenancy would automatically survive the direct tenant's abandonment or voluntary surrender of the leased

premises and should determine, in the event that it does not, whether they want the recognition agreement to govern such instances of voluntary surrender as well.

3. Failure by Sublessee to Obtain a Recognition Agreement.

It should be kept in mind, however, that all is not lost from the standpoint of a prospective sublessor if it fails to obtain some form of recognition agreement from the master landlord and/or the mortgagee. A landlord's or a lender's refusal to enter into such an agreement should not necessarily kill the deal. If a prospective sublessee believed that the commercial real estate market had not yet bottomed out, it might welcome the landlord's or lender's refusal as an excuse to reject a proposed attornment provision, thereby entitling it, without liability, to quit the premises upon termination of a senior interest and to seek less expensive accommodation elsewhere. But even if a prospective subtenant sought some of the security of a recognition agreement, it might not have to rely entirely on a formal concession from the master landlord or its lender. It might, for example, already be protected from termination in the event of mortgage foreclosure under the terms of a master lease's non-disturbance clause. And it could obtain some level of protection with respect to the eventuality of the sublessor's default by negotiating some restriction in the sublessor's freedom to voluntarily terminate the master lease. In some states, such as California, such is not really a matter for concern insofar as a subtenancy generally survives the sublessor's voluntary surrender of the premises. But in other jurisdictions, if the subtenant had failed to obtain a non-disturbance agreement, it might nonetheless attempt to restrict the sublandlord's ability to voluntarily terminate the direct lease without the subtenant's consent, for example by limiting such rights to situations involving casualty or condemnation. *See* Herz & Wohl, *Subleases: The Same Thing as Leases, Only Different* (Fall 2000) Real Property, Prob. & Trust J. 667, 684. Of course, the subtenant should also resist any provision in the sublease limiting the sublandlord's liability to its interest in the building (*i.e.*, to the direct lease), see Herz & Wohl at 688, insofar as such a provision would in effect deprive the sublessee of any remedy *vis-à-vis* the sublessor in the event either of the sublessor's default under the master lease or of the sublessor's voluntary surrender of the premises.

4. Conclusion.

Nonetheless, the fact remains that, at least in the current economic climate, subtenants should have a reasonable degree of success in obtaining such recognition agreements. On the one hand, as a result of some of the market forces discussed above, letters of intent are increasingly likely to contemplate that direct tenants may someday need to sublease, and may therefore require landlords to agree in advance to accord recognition agreements to future subtenants of some reasonable size and layout (such as full floor units at the extreme ends of multi-floor premises). And for their part, landlords and lenders often have good reason to accommodate such requests. Depending on the circumstances, it may be in the master landlord's best interest to accommodate the prospective subtenant with some form of recognition agreement, if only in order to help retain its current tenant (the sublessor) at an above-market rental rate in a period of economic slow-down. The lender might do well to accede to such requests as well, and for largely the same reasons: it wants to ensure that the property continues to be profitably occupied, both in order to ensure that the mortgagor will continue to be able to meet its mortgage payments and in order to ensure that, in the event of the mortgagor's default, the property will be able to garner a sufficient price at foreclosure sale in order for it to

comfortably recoup its investment. While the principal argument for such a concession may be that it helps landlords and lenders maximize their chances of retaining a direct tenant at above-market rent, we have seen that a recognition agreement can be negotiated in such a way as to be economically painless, from a then current market rate standpoint, even in the event that the direct tenant ultimately defaults.

Controlling the Construction of Tenant Improvements in Office Leases: A Tenant's Perspective

By Richard C. Mallory*

I. BACKGROUND

The tenant work letter is an agreement that is entered into concurrently with the execution of a lease and sets forth the terms upon which the initial tenant improvements are to be built. The work letter is unique in that it is the only portion of a real property office lease that is consistently studied in detail by several service professionals following the full execution and delivery of the lease. Following the completion of negotiations between the representatives of the landlord and tenant, the work letter will be reviewed by the construction manager, the architect/design team, the contractors, and the lenders.

Because it is reviewed by so many professionals and has such an important impact on both the amount of money that will be expended by the respective parties on the tenant improvements, as well as the timing of the cash flow to the landlord following the commencement date of the lease, this part of the office lease merits a large proportion of the legal time and attention devoted to the lease negotiation process. Despite its importance, this part of the lease is often largely overlooked by both the tenant and its counsel in favor of what may appear to be more pressing legal and economic issues in the body of the lease. This is unfortunate because the work letter itself presents several very important issues.

What drives the decision as to which party is to be responsible for the construction of the tenant improvements? Who will control the schedule, the cost, the quality of design, and the quality of construction? It all comes down to time and money, since the cost of the tenant improvements is paid for by the tenant, either directly, during the course of construction and immediately following completion, or indirectly, throughout the lease term, as a portion of the rent.

This article will analyze the factors and strategies that should be weighed by the tenant and its representatives when negotiating whether the landlord or the tenant is to control the construction of the tenant improvements.

II. EVOLUTION OF WORK LETTER ALTERNATIVES

A. Expansion

The level of detail and number of issues addressed by the work letter agreement has evolved over the last approximately thirty years as tenant improvement allowance dollars and rental dollars have steadily increased. In the 1960s, a one-page outline, which simply listed the landlord's construction obligations, would constitute the entire work letter agreement. Today's work letter may be upwards of twenty pages, treating in great depth the basics, such as the commencement date, and the incidentals, such as the responsibility for clean-up expenses. Over the last several years, sophisticated tenants have weighed the relative benefits of selecting a "tenant build with a tenant allowance" work letter option, pursuant to which the tenant constructs the initial tenant improvements, over the traditional landlord build, such as a "turn-key" or "landlord build with a tenant allowance" work agreement, all of which are discussed below.

B. Distinctions

1. Tenant Build (With or Without Allowance)

In a tenant build work letter, the tenant selects the general contractor and enters into a construction contract, typically requiring the landlord to deliver the base, shell, and core of the premises in a condition that reflects the market for "base building delivery," for example, with demolition of any previous tenant improvements completed, drywall installed around the columns and under the windows and bathroom sprinklers, and main loop air conditioning ductwork in place. The tenant manages the construction of the improvements to the premises after the landlord delivers the space in the agreed-upon delivery condition. The landlord provides a tenant improvement allowance toward the cost of the improvements, and the tenant bears all costs in excess of that allowance. The commencement date of the lease term is typically fixed but is subject to extension for delays caused by the landlord or events outside of the reasonable control of the tenant. A tenant build work letter permits the tenant to tightly control the costs, quality, and pace of construction. This may come, however, at an unacceptable price if the tenant cannot act with the speed necessary to meet the tenant's business goals. If, for example, the tenant faces an expensive holdover situation in its current space or if the tenant has potentially profitable contractual obligations that will require total focus or necessitate the tenant's immediate occupancy of its new space, a landlord-build arrangement, though perhaps more expensive, may be the best economic decision for the tenant.

2. Turn-key

In a turn-key version of the landlord build work letter, the parties approve the plans for the tenant improvements prior to lease execution, and the landlord agrees to pay for the completion of the work in accordance with those plans, regardless of the cost. The term "turn-key" derives from the idea that after the landlord completes the improvements, the tenant need only "turn the key" and begin business. Before signing this agreement, the landlord usually has already determined the cost of completing the work in accordance with the plans. The landlord enters into a construction contract with the general contractor and the architect, and the term commences upon substantial completion of the work described in the

approved plans. If the tenant requests change orders that increase the cost of the work, then the tenant pays such additional costs. Delays in completion caused by the tenant will typically accelerate the commencement date, and thus the payment of rent, on a day-for-day basis. Because early completion is all-important to the landlord, many tenants fear quality will suffer in a turn-key arrangement.

3. Landlord Build with Allowance

In a landlord build with a tenant allowance version of a work letter, the lease is executed prior to the completion of the plans for the tenant improvements, and the landlord's cost for the work is limited to a set dollar amount per rentable or usable square foot of the premises. The landlord enters into the construction contract with the general contractor, and the commencement date is determined in the same manner as with a turn-key work letter. The tenant's concern with compromise of quality for the sake of early completion remains, and to it is added another concern regarding cost control, since the tenant pays all excess costs, yet doesn't control the construction. The tenant's concerns in this situation are addressed to a great extent in Section VI below and can also be addressed by insisting that the tenant have the right to approve any change orders to the approved plans and specifications. If quality of the construction is a primary concern, then, in addition to the items described in Section VI below, the tenant should insist upon a set of specifications for all materials and items to be used or installed and, if possible, should require the landlord to commit that the construction will match the quality level of a specific suite within the building that the tenant has inspected and approved.

III. FUNDAMENTAL CONSIDERATIONS

A. Landlord's Motives

Typically, both the tenant and the landlord will seek to control the expenditure of the tenant improvement dollars. The landlord's primary concerns are economic, including receiving rent at the earliest possible date and maximizing the return on the landlord's leasehold improvement investment. The landlord also argues that as the owner of the building, it has a superior interest in controlling the construction of improvements, such as the construction of financeable and reusable improvements (*i.e.*, improvements usable by a wide variety of office users as opposed to those specially designed for a tenant's business, such as exotic computer connections or specialty signage). The landlord also has an interest in minimizing the landlord's leasehold improvement expenditures, mitigating the landlord's liability for design and construction defects, achieving uniformity in construction, taking advantage of the economies of scale that result from multiple construction projects within the building, controlling scheduling to avoid conflicts with other construction in the building, and protecting other tenants from interference with quiet enjoyment.[i]

B. Tenant's Motives

The tenant's basic objectives are conforming the leasehold improvements to the tenant's specifications and particular business needs, completing the leasehold improvements by the date necessary to meet the tenant's business objectives, minimizing disruption of the tenant's operations, minimizing the tenant's cost for leasehold improvements, and avoiding responsibility

for base building improvements. From a project management point of view, the issue revolves around control, summarized as follows:

At issue is control—control of the costs, schedule, and qualitative elements of a design and construction project. Based upon a clear understanding that tenant improvement funds are ultimately paid by the tenant, its objective is to take control of the expenditure of those funds, to gain every advantage that buying power provides, and to ensure that value judgments, compromises, and related decisions impacting time, money, aesthetics, or function are made by or in the interests of the tenant. Fundamental to this understanding is the recognition that the money will be spent, and charged to the tenant, whether work is completed as a "turn-key" or under tenant control. By acceding control to the landlord, the tenant may perceive that it has reduced its "liability," but in fact it has yielded control of a major financial investment in the operations of its own organization.[ii]

C. Factors Influencing Success

Before deciding whether to seek control of the dollars through a tenant build work letter, a smart tenant will objectively consider the factors that influence whether the tenant will be successful.

1. The Tenant's Leverage in the Lease Negotiations

The first consideration is the tenant's leverage in the lease negotiations. How badly does the landlord want or need this tenant? Does this tenant add cachet to the building? Is it taking a large space? Is the market soft? If the premises will be located in a multi-tenant office building and the tenant is a non-national, multi-locational tenant leasing an insignificant number of square feet in an up market, it is a virtual certainty that the landlord will control the construction, no matter how strongly the tenant desires a tenant build work letter. As the tenant's square footage requirement increases or the market softens, the tenant will have a higher probability of successfully negotiating to control construction.

2. The Sophistication of the Tenant Construction Manager

Another factor is the tenant's level of construction expertise. Does the tenant have an internal department specializing in design and construction of tenant improvements? Has the tenant retained a project manager with an outstanding reputation for managing build-outs efficiently and with a minimal disruption of the landlord's business affairs? An affirmative response to these questions significantly increases the tenant's likelihood of successfully negotiating the control of the improvement process.

3. External Pressures

If the tenant is under significant pressures due to an expiring lease, or must timely deliver on a contract for its goods or services, or is otherwise reacting to extreme pressure to bring the tenant improvement project in on time or under budget, the tenant may have to use all of its influence or give in on other lease points to attain control of construction.

4. Landlord's Inability to Timely Cause or Pay for the Completion of Construction

The landlord's inability to complete construction in a timely manner is another factor to consider. If the landlord is unable to obtain construction financing or to timely complete construction due, for example, to a downturn in rents or a reversal in its credit rating, the tenant may be in a better position to insist on a tenant build work letter or the right to convert to a tenant-controlled build if the landlord fails to meet certain threshold tests.

5. The Existence of Hazardous Materials or Failure to Comply with the Americans with Disabilities Act

If the building contains asbestos-containing materials or other hazardous substances that may be disturbed during construction, or if the building common areas are not in compliance with the requirements of the Americans with Disabilities Act ("ADA"),[iii] the tenant may choose to place the entire construction obligation on the landlord. Indeed, in most markets, the landlord would be required to take care of remediation of the hazardous materials and, as to the base building and the common areas (other than restrooms in a full-floor lease), compliance with the ADA, at its own cost. Landlords typically want to control this work to ensure that it is done correctly, as the landlord has an interest in the building that will outlive the tenant's occupancy.

6. The Amount of Money to Be Contributed by Each Party

What portion of the entire build-out cost does the tenant improvement allowance represent? If the tenant bears the greater cost burden up front, it will have more interest in—and more likelihood of controlling—construction costs. If the landlord is paying for most or all of the construction costs through the allowance, then the landlord will be more adamant about its right to control the expenditure of its money.

7. Relationships with Construction Industry Professionals

Construction experience nearly always favors the landlord, who should, therefore, be in a better position to obtain the most reliable contractors and architects and better economic terms, particularly when future business opportunities are likely for that group of service providers. This landlord advantage can be neutralized by the tenant's retention of a reliable and experienced project manager, or by the tenant's retention of the landlord's architect and contractor.

It all comes down to time and money: If the tenant believes it can save money by controlling the construction process and has sufficient leverage in that particular submarket and economy to insist on controlling construction, and if the tenant is not pressed for time in a manner that will weigh in favor of a landlord build, the construction of the leasehold improvements should be accomplished through a tenant build work letter.

IV. ESSENTIAL NEGOTIATION CONSIDERATIONS IN A TENANT BUILD WORK LETTER

Assuming that it is in the best interest of the tenant to control construction, and that the landlord has agreed to a tenant build, the tenant now has several key concerns in negotiating the actual terms of the work letter. These include accurately estimating the time to design and build the tenant improvements and preserving the negotiated construction period by providing for *force majeure* and landlord delays.

A. Adequacy of Time to Design and Build the Tenant Improvements

The classic battle in a tenant build work letter is over the fixed commencement date, which generally may only be extended for *force majeure* or landlord delays. From a tenant's perspective, the fixed commencement date should be determined by adding the number of days necessary for design, permitting, and construction to the date of full execution and delivery of the lease. This number should be approved by the project manager, designer, and contractor to the extent this professional team is in place by the time the parties must commit to this date. The input of the tenant's project manager in this regard is critical, as there is no date in the lease that is more critical than the rent commencement date. A tenant needs a project manager with depth of experience in order to convince the landlord that the date proposed by the tenant is appropriate. Regardless of the care taken by the tenant to propose a fair and comfortable fixed commencement date, the landlord will typically find it too long, too comfortable, and, therefore, too expensive. Once again,
the respective leverage of each party, including such factors as the size of the premises, the financial health of the tenant, the percentage of the building leased by the tenant, and the state of the market, will determine the outcome of this negotiation. Because down-time is of primary concern to landlords, a signed deal may well be more important to the landlord than the two-to six-week difference between each party's perception of the proper time frame for design, permitting, and construction. Of course, the tighter the market, the less this consideration will help a tenant.

B. *Force Majeure* and Landlord Delay Provisions

The next major negotiation issue involves *force majeure* and landlord-caused delays. These provisions need to be carefully negotiated in order to protect the benefit of the tenant's bargain as to the fixed commencement date.

1. *Force Majeure* Delay

A *force majeure* delay is a delay in the substantial completion of the leasehold improvements that is beyond the reasonable control of either the landlord or the tenant. The work letter should provide that the fixed commencement date be extended by the number of days of *force majeure* delays, as reasonably defined. To weigh fairly the parties' respective interests, three critical components need to be included in the definition of *force majeure* delays:

(a) *Industry-Wide.* The *force majeure* delay should be restricted to "industry-wide" *force majeure* delays such as strikes, acts of God (*e.g.*, earthquakes, fire, and floods) and other events that could not reasonably be foreseen by the parties, such as riot,

insurrection, unusually inclement weather, and the inability of the parties to obtain necessary materials. *Force majeure* delays should not include delays that are attributable to mistakes or miscalculations of the tenant or its representatives during the course of design or construction of the tenant improvements. One gray area is where the tenant is delayed in obtaining permits that would preclude construction of tenant improvements by any person. For example, if the tenant's plans would require parking in excess of that provided in the building, or movable partitions that are against then current code, the tenant may claim a *force majeure* delay, because construction cannot commence due to the failure of the city to issue the necessary permits. The landlord would argue, however, that such conditions are functions of the tenant plans rather than *force majeure* delays caused by governmental inaction, and the necessity of waivers should have been anticipated by the tenant's design team and is completely within the control of the tenant. The test is generally whether the *force majeure* delay would have arisen (or would have been as long in duration as claimed by the tenant), regardless of whether the design and construction of the tenant improvements had been under the landlord's control or the tenant's control. If the answer is "yes," then the *force majeure* delay is appropriate.

(b) *Notice.* The landlord needs to receive notice of the claimed *force majeure* delay from the tenant prior to the delay becoming effective. It may appear to be an onerous burden for the tenant to have to identify, document, and notify the landlord of a *force majeure* delay. The fact is, however, that the landlord is often able to abbreviate the number of days of the *force majeure* delay if it has notice of the claimed delay and can apply its resources to mitigate it. For example, if supplies are held up due to weather or strikes, the landlord may have access to alternative sources. If certain trades are on strike, the landlord may have suggestions about where the tenant might find a supply of labor to continue with the work.

(c) *Outside Date.* If *force majeure* delays stall the completion of the tenant improvements for an extended period of time, the tenant may need either to redesign the tenant improvements to eliminate the elements causing the delay or have the ability to cut its losses and relocate to alternative space. Because of this possibility, an outside date for *force majeure* delays is appropriate to allow the tenant to move forward with its business and to protect the landlord from having to adhere to a completion date that may never occur. The outside date would naturally vary with the parties' respective leverage, but it typically is a date between three and twelve months from the original fixed rent commencement date.

2. Landlord Delay

Many landlords have difficulty envisioning a landlord delay, primarily because the lease commencement date is so critically important to the landlord. Nonetheless, there are circumstances in which a landlord might take actions that delay the construction of the tenant improvements. For example, the landlord might elect to block a tenant's access to the building's loading dock in order to accommodate a major multi-floor move-in by a major tenant for the building. The landlord might also be unable to approve plans and specifications submitted by the tenant, due to illness or excessive workload. These delays are not within the tenant's control but are reasonably within the landlord's control. Landlord delay provisions should contain "cut-off" or "outside date" features similar to those suggested above with respect to *force majeure* delays to ensure that at some point the parties can move on with their business. As with *force majeure* delays, no landlord delays should be deemed to have occurred without the landlord having

received written notice of the tenant's claim for such delay. This will protect the landlord from being "blind-sided" with a claim for a large number of landlord delay days. Accordingly, the lease should provide that no landlord delay will occur without the landlord having received a written notice of the claimed delay and having had a one-business-day period to attempt to cure it. The one-business-day grace period can be limited to a total, for example, of six days, so that the one-day notice and reaction process will not be abused.

V. OTHER CONSIDERATIONS IN A TENANT BUILD WORK LETTER

In a tenant-controlled construction project, it is critical that the cash flow to the tenant's contractors not be impeded by the process in the work letter relating to the funding of invoices. In addition, the timing of the tenant's contribution and the permitted uses for the allowance may have a significant impact on the tenant's finances. The negotiation of the work letter should also focus on these concerns, as well as insurance and casualty issues.

A. Payment Schedule

The payment schedule for the contractor's invoices, from a tenant build perspective, should mirror the contractor's expectations generally in the marketplace. Payment is typically expected thirty days from submission of invoices. As with most service providers, the landlord may attempt to insert a requirement for third-party invoice approval by the landlord's lender or architect, which may result in late payments to the contractor. The landlord may insist on language for the benefit of its lender, but this may fail to take into account the fact that the tenant's credit has already been approved by the landlord and, indirectly, by the lender. Presumably, the tenant was accepted by the landlord and lender because it is financially capable of paying the rent, and the rent already includes the amortized cost of the tenant improvements. Delayed payment procedures will be inconsistent with the tenant's goals of fostering a positive relationship with those responsible for constructing the tenant improvements. Nonetheless, a landlord may be unable to change onerous payment procedures if its loan documents contain such requirements.

B. Timing of Tenant's Contribution

The tenant improvement allowance is a source of funds that should be exhausted before the tenant is forced to draw on working capital, bank financing, or other sources of funds to pay for the balance of the cost of the tenant improvements. The tenant's funds can be put to much better use in the tenant's own business, rather than prepaying for construction at a time when the landlord's allowance has not yet been spent, or even invoiced. The landlord may argue that the tenant should pay for costs estimated to be in excess of the tenant improvement allowance prior to or on a proportionate basis with the use of the allowance to assure the landlord that the tenant has the funds to complete the project. A tenant should resist this approach on the grounds that the landlord has already made a decision to rely on the tenant's financial integrity for the payment of the rental obligations under the lease, and that the landlord's requirement of such an "impound" is inconsistent with that assumption of business risk.

The tenant should also ensure early in the negotiation process that the allowance is sufficient for the tenant's needs. This is another reason to hire an experienced and reputable

project manager early in the work letter negotiation process. The project manager can help the tenant negotiate for a tenant improvement allowance that will realistically cover those costs that the tenant reasonably anticipates will be required. If a greater allowance is necessary to meet the tenant's objectives, the time for this discussion and negotiation is at the letter of intent stage.

C. Exhaustion of Tenant Improvement Allowance

Landlords typically recover the cost of the allowance over time through increased rental payments. Because the tenant will be amortizing 100 percent of the tenant improvement allowance through the scheduled rental payments, it is critical that the tenant know that it will be able to utilize all of the tenant improvement allowance. On the other hand, landlords tend to view tenant improvement allowances as a concession to the tenant and may insist on negotiating limits on the use of the tenant improvement allowance. For example, the landlord may attempt to limit the use of the allowance to the payment of improvements that will remain in the premises or have some residual asset value at the end of the term. If the landlord takes this position, the tenant should then request a rental reduction formula based on the amount of the unused allowance or should request application of the allowance to the moving costs and the cost of furniture and telecommunications installations. Such a concession generally assures the tenant that it will utilize all of its allowance, because the tenant improvement allowance is typically less than half of the total cost of the move to the premises, after taking into account moving costs and costs of installation of furniture and equipment.

D. Insurance

A tenant-controlled work letter may require specific insurance coverage during the course of construction or may reference the general insurance obligations of the tenant contained in the lease. An insurance requirement in the work letter may be unnecessary in the case of a landlord build, simply because the landlord has already assured itself of compliance with its internal insurance requirements or its lender's or partners' insurance requirements through its own coverage combined with its contractor's insurance. Any special insurance requirements related to the construction of the leasehold improvements will need to be specifically addressed in the work letter agreement. Fundamental insurance issues include the acquisition, by the general contractor, of workers' compensation insurance as required by law and builder's risk insurance covering the existing tenant improvements and the improvements to be constructed, all pursuant to standard industry custom and practice. Since the lease should always address indemnity issues, the work letter should incorporate them by reference. The representatives of both the landlord and the tenant should also ensure that the language of the work letter includes liability insurance coverage, either by specific provision for it or by incorporating by reference the insurance provisions in the lease.

E. Casualty During Course of Construction

The allocation of risk of loss during the course of construction should be designed to address the same issues that are addressed in the damage and destruction provisions of the lease, including the following: (1) extending the scheduled completion date and adjusting the allowance as a consequence of the casualty; (2) placing insurance proceeds in a trust account for disbursement as restoration work proceeds; and (3) specifying the parties' respective

responsibilities for deductibles and other uninsured costs.[iv] The tenant should be entitled to terminate the lease after a casualty if the contractor in charge of construction is unable to certify to the parties that the leasehold improvements will be able to be substantially completed within an agreed-upon time period. The time period should reflect the time it would take for the tenant to initiate a search for new space, negotiate a new lease, design and obtain permits for the construction of tenant improvements, and complete the construction. This time period is appropriate because the landlord, given its investment in the lease as of the date of the casualty, should be at least on an equal footing with third-party landlords in attracting the tenant to build out improvements and lease space in its building. This could only be accomplished by allowing an adequate time period for the landlord to demolish the existing damaged improvements and complete construction of the leasehold improvements pursuant to the approved plans and specifications. Because the lease has already been negotiated and the plans and specifications have already been completed, the landlord suffering the casualty should be at a competitive advantage in retaining the tenant based on this timeline.

VI. NEGOTIATION CONSIDERATIONS IN A LANDLORD BUILD WORK LETTER

If a tenant is unable to negotiate a tenant-controlled work letter, the tenant's attorney must protect his or her client from the pitfalls of the landlord build work letter. The tenant's primary concerns are discussed in this section.

A. A Broadly Defined Definition of Substantial Completion

In a landlord build work letter, the tenant's rent obligations will begin on a date that is tied to the definition of substantial completion. Substantial completion of the tenant improvements should be defined to mean the date as of which (i) the general contractor in charge of construction certifies to both parties that the work of improvement has been completed pursuant to the approved plans, subject to a reasonable punch list and to any fixtures or equipment to be installed by the tenant and (ii) the tenant can legally occupy and commence to operate its business within the premises. The second element requires that there be no impediments to the use of the critical common area facilities such as parking, lobby, and elevator and that a temporary certificate of occupancy has been issued. If the tenant will be taking possession of the new premises while continuing to occupy its existing premises, the tenant should negotiate for the right to "phase-in" the rent based on the proportion of the space being utilized for the tenant's business, with a fair outside date for full term commencement.

B. The Definition of Tenant Delay

A tenant delay can be any event that is reasonably within the control of only the tenant. The tenant delay feature of a landlord build work letter should be fine tuned to require notice to the tenant and a one-business-day cure period, with a total of up to six to ten "free days" of tenant delay without penalty over the course of the build-out. The basis of the notice requirement is to give the tenant the opportunity to limit the accumulation of tenant delay days, because proactive and creative cooperation with the landlord can mitigate or eliminate most of these delays. Some long lead time items can be readily available if the parties focus in advance upon solutions. To the extent that long lead time items are fundamental to the tenant's business

and the landlord has been made aware that the tenant will require them the commencement date should be designed to accommodate the time for such items and they should not be treated as causing a tenant delay. All tenant delays should be calculated on a net critical path basis, meaning that they are days of actual delays in the substantial completion of the tenant improvements, after adjusting for all delays caused by or contributed to by the landlord.

C. The Condition of the Premises Prior to Application of the Tenant Improvement Allowance

One of the most important features of a fairly and fully negotiated work letter agreement is a detailed description of what the landlord will be providing toward the improvement of the premises prior to the application of the tenant improvement allowance. This should include full treatment of the issue of demolition of existing improvements, so that the tenant can make an accurate comparison of alternative locations. If, for example, a landlord is requiring that a tenant install the entire main duct and branch distribution for the heating, ventilating, and air conditioning system, and the landlord's competitors have preinstalled the main ducts and are only charging the tenant for the cost of the branch distribution, the respective rents and other factors affecting rent can be adjusted and weighed to assure that the correct net rents have been assigned to the competing locations.

VII. CONCLUSION

With a coordinated team of expert consultants on board, and with a little leverage, a tenant should be able to convince a landlord to agree to a tenant build work letter. This should allow the tenant to maximize its potential savings in the construction of the improvements. If the tenant must accept a landlord build, it should negotiate carefully the terms of the work letter to ensure timely completion of the expected quality of tenant improvements. At issue is control, and it all comes down to time and money.

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[i] *See* D. Summers, D. Morrow & J. Tipton, *Leasehold Improvement Agreement Exhibit* in CEB Office Leasing: Drafting and Negotiating the Lease, § 40.3, at 838 (1996) [hereinafter *Leasehold Improvement*].

[ii] Jeffrey R. Gingold, *Coordinating a Team of Experts*, CLE International Tenant Improvement Agreement Conference, Los Angeles, California, § I, at 1 (1997).

[iii] 42 U.S.C. § 1201 *et seq.*

[iv] *Leasehold Improvement, supra* note 1, at 877.

NOTES