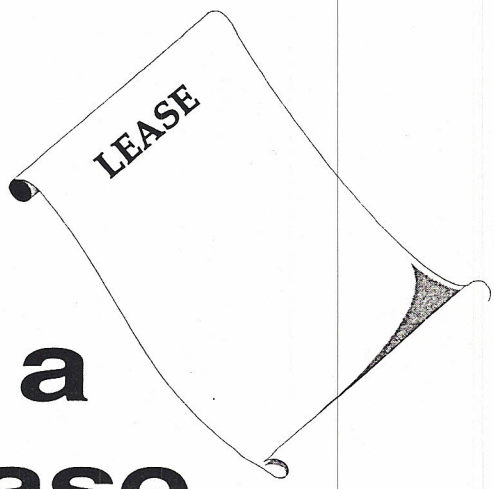
Tenants' Rights in a Lease



by Stan Mullin, CCIM, SIOR, and Richard L. Riemer, Esq.

This article addresses four topics, common to commercial real estate leases and briefly describes either the rights that a tenant typically has in relation to the landlord or the provisions you might suggest be included in a lease when you are representing a tenant. This synopsis cannot address the intricacies of any specific transaction, since landlord and tenant laws vary from state to state. We recommend that you consult with local legal counsel who specialize in real estate law before making a binding commitment.

1 Offset Rights

If a landlord fails to perform his obligations pursuant to the lease, can the tenant perform the obligations and deduct any cost incurred from rent due under the lease? The ability, perceived or real, for the tenant to use self help under these circumstances is one of the greatest threats to a landlord. Even if the tenant does not have the contractual or legal right to self help, the landlord may well find it difficult to convince a judge of the merit of his case against the tenant if the landlord has not complied with his obligations under the lease.

Unlike some types of contract law, which allow one party to a contract to withhold performance of its obligations if the other party has breached the contract, most states require the parties to a lease to continue to perform their obligations. This is true even when the other party is in default or breach. While many states have adopted laws that give residential tenants certain self-help rights, those rights generally have not been extended to commercial tenants. If commercial tenants are not provided with these rights, what can they do if their landlord does not fulfill his or her obligations? In some states, the courts have ruled that if the landlord is not performing obligations under the lease, he or she has constructively evicted the tenant. This relieves the tenant of the obligations under from the lease and allows the tenant to move elsewhere. If the tenant stays in possession, however, he must pay rent. This does not, therefore, provide much assistance to those tenants for whom it would be impractical or expensive to move to an alternate building.

If the property with which you are dealing is in a state that does not allow self help, you may wish to suggest modifying the proposed lease to provide the tenant with the right to fulfill the landlord's obligations if they are not met within an agreed-upon period after appropriate notice, then deduct the cost thereof from future rent. You might also wish to suggest that the lease specifically state that the tenant's obligation to pay rent is a covenant contingent on the landlord's performance of his or her obligations.

2 Capital Expenditures

Sometimes, near the end of the lease term, a landlord notifies the tenant of plans to make certain major repairs or capital improvements—roof repairs, for example—to the property. While leases often require the landlord to maintain the roof, building exterior, parking lot, and common areas, sometimes projects characterized as routine replacement or maintenance represent a thinly veiled excuse to renovate the property at the tenant's expense so as to make the building attractive to prospective tenants after the current tenant's term expires. Landlords who have billed tenants to reroof, repaint the building, resurface the parking lot, or renew the landscaping under such pretenses have motivated the revision of many leases around the country during the last few years. A tenant's advisor can help mitigate or prevent this type of problem by stipulating that the landlord allocate the tenant's obligation to pay for these types of expenses over the period of expected

usefulness to the tenant. If a new roof has a useful life of 20 years and two years remain on the term, the tenant should only be obligated to pay 10 percent of the cost of the roof in equal installments during the last 24 months of the term. You may, therefore, wish to include language similar to the following in your lease:

> *"...the cost thereof shall be prorated between the Parties. And Tenant shall only be obligated to pay, each month during the remainder of the term of this lease, on the date on which Base Rent is due, an amount equal to the product of multiplying the cost of such replacement by a fraction, the numerator of which is one, and the denominator of which is the number of months of the useful life of such replacement, as such useful life is specified pursuant to Federal income tax regulations or guidelines for depreciation thereof (including interest on the unamortized balance as is then commercially reasonable in the judgment of Landlord's accountants), with Tenant reserving the right to prepay its obligation at any time."*

"The tenant should attempt to obtain an ongoing right of first refusal . . ."

But what if the capital expenditure is government mandated? If such a capital expenditure is mandated by a governmental agency as a result of tenant's specific use of the property, typically the entire cost is borne by the tenant. You may attempt to have the landlord pay for the share of the cost that is equal to the percentage of the improvement that is likely to have reversionary value to the landlord. If, on the other hand, the subject capital expenditure is required in the building regardless of use (such as natural hazard mitigation—seismic modifications, energy efficiency, etc.), the cost burden can be shared between the landlord and the tenant based upon the remaining term of the lease and other similar factors. A lease provision that splits the cost in the same fashion as suggested in the paragraph above is a good alternative. If these expenditures are mandated near the end of the term, the landlord should have the right to terminate the agreement if the cost is too burdensome. The tenant should have the right to terminate the lease if the landlord does not pay a rightful share. The tenant should pay the landlord's share and offset that cost against rent due. A similar approach can be used with other cost-sharing issues such as the remediation of environmental contamination not caused by either party or damage due to natural hazards (e.g., ice storms, earthquakes, wind, etc.).

Right of First Refusal

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Many tenants will want the right to either acquire the property or take additional space during the term of the lease. As a rule, the first rights of refusal benefit only the tenant because they limit the landlord's ability to sell or lease portions of the property. However, often the landlord grants such concessions to entice a tenant into entering into a given lease. Care should be taken to draft such provisions carefully to eliminate any misunderstandings. The tenant should attempt to obtain an ongoing right of first refusal that will provide the first-right alternative throughout the term. If the right is one time the tenant may face an opportunity to purchase or expand early in the term when he or she is still getting established in the property and may not have the need for additional space or the cash available for the purchase. If the tenant is limited to the one occasion, it defeats the intended purpose of the right. As long as any first-right provisions typically require the tenant to pay a fair market rental or price, the landlord, who is selling the property should not be unduly harmed by providing a continuing right throughout the term.

In addition, clarity as to who may exercise these rights is important—especially with regard to first rights of refusal to purchase. For example, the principals in the tenant company may wish to exercise the right to purchase in their own name rather than have the tenant make such a purchase. In appropriate circumstances, one might also wish to address how these rights are to be treated if the tenant's partnership is dissolved.

Where a right to purchase is being granted, the landlord typically must fully negotiate the terms to a sale, then provide notice of the terms to the tenant, providing a time period in which the tenant must match those terms (typically one to three weeks). If the tenant does not respond within the allotted period, the landlord may proceed with the initial sale and the tenant's right to purchase is extinguished. Where a right to expand is granted, the landlord typically is required to notify the tenant at least 30 days in advance of the pending availability of the subject space.

Subordination, Non Disturbance, and Attornment Agreements

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If a tenant is making substantial tenant improvements to the space, the building is uniquely suited to the tenant's use, or the landlord is at substantial risk of defaulting on its loan commitment, the tenant should request a Subordination, Non Disturbance, and Attornment Agreement from the landlord's lender so that the tenant's lease will not be voided in the event of a foreclosure on the property. Be aware that each state differs in its handling of this issue, and this area of the law is far too complex for this article. By way of illustration, however, California uses a "race notice" system which establishes priorities between interests in real estate. Typically, the party who records his or her interest first takes priority over later attaching interests. In this system, the foreclosure of a senior deed of trust can terminate junior interests (i.e., a lease agreement) in the property.

Is a lease automatically extinguished when the lease is executed after the deed of trust was recorded against

the property (which is typical with property encumbered with a loan), and the deed of trust was subsequently foreclosed upon by the property's lender? Can the purchaser at the foreclosure sale void the lease even if the tenant is in full compliance?

"Can the purchaser at the foreclosure sale void the lease even if the tenant is in full compliance? "

A 1997 California decision in the case of Miscione v. Barton Development Company held that the lease was not extinguished because the lease contained an attornment provision (a provision wherein the tenant agrees to recognize a buyer at a foreclosure sale as landlord). The court found that the buyer at the foreclosure sale could elect to either void the lease, since there was no subordination agreement, or the buyer could agree to recognize the lease and have the tenant attorn to it under the provisions of the attornment provision. Since the buyer had accepted rent from the tenant, the court held that the buyer had recognized the lease notwithstanding the priority of the deed of trust.❖

Stan Mullin, CCIM, SIOR, Grubb & Ellis, Newport Beach, California is a senior vice president of the firm, with a focus on corporate real estate. You can learn more about his firm at www.grubb-ellis.com.

Richard L. Riemer is a real estate attorney in private practice in Santa Ana, California, and is the attorney for the Forms Committee of the American Industrial Real Estate Association.

Please contact Stan Mullin if you would like suggested language to address some of the topics covered in this article.

For more discussion on lease clauses, join Stan Mullin at the Montreal Convention and attend his Sunday morning breakout session and swap of Innovative Lease Clauses.