

## What to Watch for When Negotiating Commercial Office Leases

*Your association makes a big financial commitment when it enters into a lease agreement for office space. To get the best outcome, make sure you understand the legal and business issues you will need to negotiate with a potential landlord before you sign on the dotted line.*

By Jim Wilson and Steve Burman

If your association is like many, the lease for your headquarters office may be the most important contract to which your organization is a party. Not only do most leases typically have a much longer term than other contracts, but the financial obligations likely are among the largest in your budget. Also, since the lease governs your association's occupancy of its office, it can materially affect how you and your employees and visitors go about your daily business.

For these reasons and more, associations need to exercise due care in selecting office space and negotiating the business and legal issues that will form the basis of the relationship with the landlord. These issues are addressed in the lease agreement, but the process of negotiating and resolving them begins well before a lease is signed.

Before executing a formal lease document, a prospective tenant will visit and compare various office space options and will negotiate a letter of intent with the future landlord that will address many substantive business and legal matters. Therefore, it can be beneficial to engage qualified real estate and legal advisors early. The earlier this process begins, possibly as many as 24 months in advance, the more office space alternatives are likely to be available and the more leverage you are likely to have in lease negotiations.

The following are some of the important issues to consider in the process of finding and securing office space.

### Financial Considerations

**Square footage and rent.** Most rental rates in association office leases are based on the *rentable* square footage of the premises, rather than the actual *usable* square footage. Usable square footage refers to the measurement from interior wall to interior wall within the leased premises (the area that the tenant actually occupies and uses exclusively). Rentable square footage includes the tenant's proportionate share of common areas such as lobbies, corridors, and shared bathrooms.

All else being equal, tenants generally would prefer that more of their rent dollars go toward space that they exclusively occupy, rather than toward common areas. This is not to say that rent per usable square foot always is the determining factor when comparing office options (for example, one building may have a more spacious and inviting lobby and therefore be more desirable), but it should be in the mix of information you consider.

Of course, you also need to consider the space into which you will move. If it needs a substantial build-out to prepare it for occupancy, you can expect significant upfront

construction costs and you may be delayed in moving in. A landlord frequently will provide financial allowances for a tenant to rebuild, alter, or redecorate office space and may grant additional concessions such as free rent (rent abatement) for a period of time to help the tenant avoid paying rent for two offices while that work is being done. Be sure to consider the value of any concessions in comparing various leasing options.

**Lease term.** It is not unusual for associations to sign office leases that extend five, 10, or more years into the future. A lengthy commitment provides a degree of certainty and stability, but it also presents risk if your real estate needs or ability to pay rent change over that period.

Longer lease terms tend to be preferable to landlords because of the considerable upfront costs associated with moving in a new tenant, including construction costs and allowances related to the interior build-out. The landlord will factor these costs into your annual rental obligation. Accordingly, your lease may resemble a loan transaction, with you repaying upfront landlord costs over time as part of your monthly rental payments.

Carefully consider the costs and benefits of different lease terms. While shorter terms can provide more flexibility, longer terms allow for repaying the initial landlord expenses more affordably over time.

**Options and rights.** You should consider ways to mitigate the risk that your real estate needs may change during the lease term. For example, the lease could allow you to expand your office space within the building during the lease term (this is often called a right of first offer), or to renew the lease term for additional periods. You might also be able to negotiate a right to terminate the lease before its scheduled expiration, but this provision may include an early-termination fee to fully compensate the landlord for its upfront expenditures.

Even without these options, your right to transfer the lease or sublease all or some of your office space during the term can provide much-needed flexibility. For example, years after signing a lease document, you may need substantially more or less space than originally contemplated. You may have added staff and need to expand your space (whether in the same or a different building), or you may need to reduce your space and obligations under the lease for financial reasons. In either case, transfer or sublease rights will provide you flexibility to find more suitable space.

A landlord, on the other hand, will seek to maintain maximum control over leasing and occupancy of the building. The landlord may be reluctant to grant special renewal, expansion, or termination rights and probably will want the right to approve or reject each proposed lease transfer or sublease transaction. Because of the importance of these provisions to each party, they frequently are a focus of lease negotiations.

**Security deposit.** A security deposit provides a landlord with a degree of protection from tenant default, but it can be a significant expenditure for the tenant on the front end of a lease. Security deposits can be held by landlords as cash, or the tenant may

provide a letter of credit from an agreed-on financial institution. Whatever form the security deposit takes, the dollar amount will be a matter for negotiation.

Under certain circumstances, you can negotiate for the initial deposit amount to be reduced (or “burned down”) over the lease term. For example, upon receiving 36 months of rent, a landlord could credit back all or part of the deposit. The security deposit has become a hot topic among landlords over the past five years, so be sure to pay close attention to it during the negotiation process.

These business issues must be discussed long before a draft lease is presented to a prospective association tenant, and they may well be resolved in a preliminary letter of intent. The following risk management issues may also be addressed in a letter of intent, but more frequently they are the subject of negotiation after the landlord’s counsel has presented a draft of the lease document.

### **Risk Management Issues**

**Indemnification and insurance.** Owning or occupying real property can create material legal exposure, and a large part of the lease negotiation involves determining how that exposure is allocated between landlord and tenant.

The first draft of an office lease from the landlord’s counsel is likely to contain broad indemnification obligations from the association tenant in favor of the landlord. It may, for example, require you to hold the landlord harmless from any loss or liability resulting from your occupancy of the space. It could impose on you responsibility for the acts of your employees and agents, as well as any visitors to your office. The result could be substantially more liability exposure for your association. The extent to which your counsel can negotiate your indemnification obligations, and even those of the landlord, will depend on the circumstances of the particular lease negotiation.

The lease also will require you to maintain certain insurance coverage throughout the lease term. This is likely to include insurance covering your association’s furniture, computers, equipment and other property, and any alterations within the premises, and liability insurance for losses resulting from the organization’s acts or omissions. The lease might also require coverage for business interruption, workers’ compensation, and construction projects. Reviewing a lease’s insurance requirements can be a helpful exercise in any event, in that it provides an opportunity to think about and manage areas of liability exposure.

Work with your insurance representative to make sure that you carry all of the insurance expressly required by the lease. Also review your insurance in light of the indemnification obligations in the lease. It might be wise to procure additional insurance, if available, to minimize any potential uninsured liabilities that your association would be assuming.

**Waivers.** Certain liability waivers may be mutually beneficial, such as a provision under which each party would first look to its insurance carrier to cover losses to its property, even if those losses were caused by an act of the other party. However, your counsel

should review any other waivers and limitations of liability in favor of the landlord to minimize the potential negative impact from uninsured losses.

Selecting optimal office space and negotiating a favorable lease can be crucial to an association's future, especially considering the size of the expense involved. Although the process is often time consuming, it is important to devote adequate time and resources to getting it right. Considering these issues will help you get the best possible outcome for your association.

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