Commercial Property Executive

Beware of Hidden Issues in Commercial Leases: Part II

By Scott Biel
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Full disclosure of expenses can put landlords on a more level playing field, says Scott Biel of Solomon Ward Seidenwurm & Smith.

Making commercial property transactions more efficient, with greater certainty in the allocation of risks and costs, is a common goal of parties to commercial lease and sale transactions. In a recent article, my partner, Stephen Toohill, discussed how landlords and tenants can both benefit from reaching a general understanding on standard leasing risks and expenses that are likely to arise during the term of the lease.

When parties agree upon a basic or minimum annual rent in a letter of intent, it is based on the presumption that the tenant has sufficient information to understand the market value of the subject property, and a presumption that the landlord's base rent is consistent with that market value. In a triple-net lease transaction, however, the gross expense of the tenant's lease obligations can (and often does) substantially exceed the base rent agreed upon in the letter of intent for several reasons that are capable of analysis prior to the parties' execution of a letter of intent.

For example, deferred costs of building maintenance and replacement of obsolete equipment, deferred compliance with legal requirements (such as ADA access requirements or carbon emissions caps), and the costs of bonds or association payments for initial project development, are rarely addressed in the letter of intent. Some brokers would indicate that these are legal issues and outside the purview of their engagement, while others may try to mitigate their clients' gross expense liability by limiting annual increases in "controllable expenses."

As a comparison, let's consider the process of leasing or purchasing a motor vehicle. Before the internet, that process usually involved visits to multiple car dealerships over days or weeks, with little transparency of comparative risks and costs of similar vehicles. Over the past 30 years, that process has undergone a paradigm shift, now requiring minutes of on-line research and, often, resulting in an on-line purchase that can be closed in less than a day.

If the current practice of marketing and leasing of commercial space is to achieve the transactional efficiency that the internet has achieved for other industries, a first step would be full disclosure of the "hidden" expenses in leasing commercial space. Why should landlords, who engage in good maintenance and management practices, be willing to compete on an uneven playing field with less diligent landlords?

Why Insurance Coverage Counts

The cost of insurance is one example. Lower insurance costs for Building A as compared to Building B could mean any of the following: (i) Building A's insurance coverage places its tenants at greater risk of liability for the cost of high deductibles or of their leases being terminated due to a casualty;
(ii) Building B's insurance coverage exceeds the "market standard" insurance coverage maintained by the owner of Building A; or (iii) Building B's life-safety systems are outdated or its owner engages in poor management practices, making its cost of the same insurance maintained by the owner of Building A more expensive.

Another example is regulatory compliance costs. Are both Buildings A and B fully compliant with ADA access requirements and local carbon emissions caps? If not, what is the comparative cost of compliance (or additional estimated costs of fines or carbon offset costs, for non-compliance)? What about the comparative assessed value of Buildings A and B? Are they both consistent with their current market value if any tax reassessment occurs?

These are only a few examples of information that can be included in a standardized disclosure report to inform the parties' respective presumptions underlying the base rent amount in a letter of intent.

If transactional efficiency is truly an industry objective, occupancy costs should become more transparent to tenants in the marketing of commercial space. Brokers have the ability to assist their clients—both landlords and tenants—in identifying and providing information on market comparisons of occupancy costs. With better transparency, parties can more quickly and efficiently agree on fairly allocating those risks and related costs.

Scott Biel is a partner at Solomon Ward Seidenwurm & Smith LLP.

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