

Practical provisions for commercial leases in light of changing times

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Over the last two years, lawyers' standard lease language was tested by natural disasters, the pandemic and drastic changes in the way people work. To adapt to changing times, attorneys should consider incorporating a variety of practical provisions into their corporate leases regarding term, base and additional rent, casualty insurance, premises rights, and force majeure.

Lease terms

Tenants are asking for longer terms, not shorter, to protect against market uncertainties, including inflation. But tenants are also trying to hedge their bets, remembering how Covid-19 affected their businesses.

There are a few legal tools for tenants to address this. The first is to include one or more termination options in favor of the tenant, at fixed times. The second involves kick-out provisions. These allow the tenant to terminate the lease if a casualty or government-declared health emergency results in external conditions or a governmental order that reasonably causes the tenant to be unable to conduct its business for a specified period of time.

Base rent

Attorneys should consider incorporating pandemic-related and casualty-related provisions, as well as addressing the effects of inflation, in the base rent terms of a lease.

Tenants are remembering the delicate negotiations that arose during the pandemic, where landlords often allowed some combination of rent abatement, rent reduction, and rent deferral. Now, tenants are trying to negotiate clauses that build in one or more of these elements upon the occurrence of specified events in the future, such as a declared health emergency that results in a governmental order that reasonably causes the tenant to be unable to conduct its business at the leased premises.

Most often there is a trade of rent deferral for an extended lease term. The landlord will, for example, allow a 30% reduction in base rent in exchange for the tenant's agreement to repay the deferred amount over a lease term that is longer than what was originally provided in the lease, thus allowing the landlord to recover its lost revenue.

What about the effects of a catastrophic casualty like a major hurricane? That is a matter for business interruption insurance.

Landlords and tenants must make sure that the party who is required to carry property/casualty insurance is also required to carry business interruption insurance. If that party is the tenant, then the lease should clearly indicate that the tenant's rent obligations continue despite any casualty.

Inflation is another current social/economic trend that is causing landlords and tenants to take a closer look at Consumer Price Index-based increases in rent. Leases often place caps on CPI increases in base rent. Landlords facing inflation rates of 7 or 8% are now regretting those 2% or even 5% caps, and future leases are less likely to contain such limits on rent increases.

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Tenants, on the other hand, are seeing the importance of having limits on CPI increases. Strong tenants will be trying to obtain low caps on CPI increases.

Casualty insurance

More severe natural disasters have taught us not to take casualty insurance provisions for granted. There are many questions to consider in order to address the myriad of issues that can arise.

What determines if a casualty is so severe that lease termination is allowed? Is it based on the length of time for restoration, the cost of restoration, or the percentage of the total square footage of the leased premises and/or the development that is damaged? Other factors to consider include a lack of access to the premises and whether the premises have otherwise become unfit for the intended uses.

Who has the right of termination, landlord, tenant or both? If termination is not allowed, what are the possible pitfalls to getting

the premises restored? Is the landlord only obligated to make repairs to the extent of available insurance proceeds? This is a problem if the landlord's lender takes the proceeds instead, or if the landlord's insurer is slow to pay or provides an inadequate amount. The tenant could protect itself through a right of termination related to these issues.

What if the landlord runs into extended delays in completing the restoration? To address this issue, the tenant could try to negotiate a termination right after a specified time period. In that case, the tenant should be willing to give the landlord a specific notice that the tenant intends to terminate, with an additional time for cure, to allow the landlord to expedite the job.

Which party is obligated to carry the casualty insurance? That needs to be the same party who is obligated to restore the premises.

Who is required to insure what? Often the landlord is required to insure the shell of the building, and the tenant is required to insure its "betterments." Under this arrangement, it is critical to define what constitutes "betterments" and the building shell.

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These casualty insurance provisions also need to be coordinated with the provisions about rights and remedies after the occurrence of a casualty.

Also, remember that business interruption insurance is only available to the party who is carrying property/casualty insurance. If the landlord is the party required to carry property/casualty insurance, but the tenant is required to pay rent despite the occurrence of a casualty, then the tenant could find itself without insurance proceeds with which to pay the rent.

Finally, COVID-19 taught us that a pandemic does not constitute a "casualty" for the purpose of triggering casualty and business interruption insurance. Therefore, tenants need to pay particular attention to whether they are required to continue to pay rent in that case.

Additional rent

Recent events have presented surprises to both landlords and tenants on the usually prosaic topic of the tenant paying its proportionate share of the landlord's operating expenses.

Tenants are often surprised to learn that the landlord's deductible under the landlord's property/casualty insurance is part of the operating expenses for which the tenant must pay its proportionate share. A catastrophic hurricane, combined with a hurricane

deductible of 3%-5%, can lead to a deductible in the millions of dollars.

Additionally, increased vacancy rates have brought attention to the "95% gross-up" provision found in most leases. This provision generally provides that, when building operating costs will be passed through to the tenants on a proportionate basis but the building is not yet fully occupied, the landlord can "gross up" or overstate its variable operating costs as if the building is 95% occupied in order to reflect the expenses the landlord will incur once occupancy increases.

In an office lease with a base year, this clause is essential for a new tenant. Vacancies might be causing a landlord's present expenses to be understated, and when occupancy rates rise, the increase in operating expenses over the low base year could be a problem for the tenant.

In a retail or industrial lease, on the other hand, the landlord customarily passes through all of the operating expenses, so a tenant in a building that is only 50% occupied could end up paying almost double the costs that would be allocated to its space on a pure percentage basis. The tenant therefore wants to try to negotiate a cap on variable expenses.

The premises and related rights

The popularity of remote work is causing tenants to seek flexibility in the size of their spaces. This has led to provisions allowing for a reduction in the size of the premises at specified time intervals. Similarly, more flexible schedules mean tenants want the ability to reduce the parking spaces they pay for — and perhaps to increase them, if trends change.

Force majeure

It's more important than ever to scrutinize Force Majeure provisions because they need to be coordinated with all of the new lease provisions discussed in this article.

First, each party to a lease needs to determine whether the Force Majeure clause does or does not grant relief from monetary obligations like the payment of rent. Landlords say "no," and tenants try for (but almost always fail to receive) "yes."

Some Force Majeure events, like a hurricane, will also be covered by the casualty provisions of the lease. So, the provisions on these two subjects, including rent abatement, need to be coordinated.

The Force Majeure provision should also specify what does or does not constitute a Force Majeure event. Concerning an event like COVID-19, there are two questions an attorney should ask. First, must it be a government-declared health emergency? Second, is it the existence of that emergency (the pandemic or epidemic) itself that is the Force Majeure event, or is it the governmental order (quarantine or stay-at-home order) that flows from it?

A careful tenant might also want to add specific language defining Force Majeure to include utilities and access.

Two examples are:

- (1) "Disruption or failure of utilities preventing use of all or substantially all of the premises for XX consecutive days"; and
- (2) "Physical conditions preventing access to all or substantially all of the premises for XX consecutive days."

Conclusion

Leases last a long time and need to be flexible documents. The good news is that attorneys can build in provisions now that will give the parties guidelines for determining their rights and remedies no matter what changes arise in the future.

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