

Real Estate for Nonprofits: *A Guide to Leasing (and Subleasing)*

Amy B. Rifkind

(202) 942-6137

Amy.Rifkind@aporter.com

Alex C. Hallett

(202) 942-6588

Alex.Hallett@aporter.com

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This summary is intended to be a general summary of the law and does not constitute legal advice. You should consult with competent counsel to determine applicable legal requirements in a specific fact situation.

Why Lease/Sublease Rather than Buy?

■ Pros:

- **Simplicity:** Single agreement with Landlord (lease); obligations limited to leased premises; no property management obligations
- **Flexibility:** Ability to expand or contract premises (via options, subleasing, expiration of lease term, etc.)
- **Financing of Improvements:** Allowance often provided by Landlord for initial improvements (Tenant pays back over the lease term through rent)
- **Balance Sheet:** No mortgage
- **Limited Liability:** Tenants are not exposed to liability in the same manner as owners of real property (environmental risks, code enforcement, casualty, condemnation, etc.)

■ Cons:

- **Control:** Must rely on Landlord to perform obligations under the Lease; no direct relationship with property manager or service providers; no alterations unless approved by Landlord; no/limited signage rights; etc.
- **Financial:** No appreciation and limited ability to depreciate costs of improvements

The Leasing Process: An Overview

- Hire a broker to find space
- Tenant and broker establish Tenant's goals
 - space needs and growth/reduction projections
 - location (accessibility of public transit, etc.)
 - preferred amenities
 - term (including coordination with existing leases)
 - rental rate range
 - parking requirements
 - project-specific needs (grant and contract award specifications, if any)
 - Timing
- Broker finds space
- Landlord and Tenant (or, often, their brokers) negotiate and sign letter of intent
- Negotiate and sign lease (including exhibits)
- Build-out
- Occupancy

The Tenant Leasing Team: Key Players

- Broker
- Attorney
- Architect
- Contractor (and subcontractors)
- Insurance/Risk Consultant

Letter of Intent (aka Term Sheet)

- Who is Tenant; who is Landlord
- What space is to be occupied (attach drawing or schematic)
 - “4,000 sf on the 5th floor of the Building (defined above) in the location shown on Exhibit A”
- What is the rent (basic rent, escalations and pass-throughs)
- How long is the lease (___ years)
- When does it start; when does it end
 - (commencing on _____, expiring on _____)
- When is the Tenant entitled to take possession
- When does rent commence
- Will there be rent abatements?

Letter of Intent Terms (cont.)

- Delivery Condition: Landlord improvements before occupancy (painting, carpeting, moving demising walls)
- Will Landlord provide a Tenant improvement allowance?
 - Commitment by Landlord to fund a certain amount of the initial improvements in the premises (whether constructed by Landlord or Tenant)
- Security deposit (subject to Landlord review of financials)
 - Often significantly greater than 1 month of base rent for nonprofit tenants
 - Landlord may seek to review project, contract and grant awards
- Guaranties
- Options (FLEXIBILITY):
 - to expand or reduce square footage over time
 - to renew the term or terminate early
- (Largely) non-binding

Factors That Influence Economic and Business Terms of Lease

- Size of Tenant: *Tenants leasing small premises generally will have less bargaining strength*
- Size of Tenant space in relation to overall size of building
- Motivation of Landlord: *High vacancy will make landlord more reasonable*
- General market conditions
 - Location of property
 - Vacancy rates in surrounding buildings

Lease Negotiation Process

- Landlord customarily prepares first draft
- Frequently a form will be used
- Critical to have a lawyer review to:
 - Confirm business terms from letter of intent
 - Negotiate to delete onerous, non-standard clauses
 - Address particular Tenant concerns
 - Understand how the pass through of expenses and taxes works

Rent

Concepts:

- Gross Rent = the basic rent payable by Tenant that includes costs for operating expense and taxes.
- Net Rent = the basic rent payable by Tenant that is allocable exclusively to Tenant's lease of the property, exclusive of all other costs (e.g., exclusive of any operating expenses and taxes).

Types of Deals:

- Full Service Lease = a lease where the base rent includes operating expenses and taxes for the base year (*i.e.*, a gross rent concept). Tenant only pays its proportionate share of the INCREASED costs of operating expenses and taxes over the base year because the base rent includes such costs for approximately the first year.
- Net Lease = a lease where the base rent paid to Landlord does not include any payment for operating expenses or taxes, even for a base year. Triple Net refers to base rent net of (1) operating expenses, (2) taxes, and (3) insurance (which is typically included in the calculation of operating expenses). Tenant is responsible for paying, for its share of operating expenses and taxes allocable to the premises IN ADDITION to the base rent (where no base year concept exists).

Key Lease Terms

- Operating Expenses
 - Pass throughs of actual operating expenses
 - Pro rata share
 - Monthly payments
 - Annual estimates
 - Audits/reviews
 - Exclusions (e.g., debt service, capital expenditures, excess management fees, amounts reimbursed by insurance, services provided exclusively to other tenants)
- Taxes

Key Lease Terms (Cont.)

- Services/Utilities
 - Identify services to be provided (Landlord has no obligation to provide services that are not provided)
 - Establish standard for services (e.g., janitorial specs; temperature ranges for heating and cooling)
 - Landlord should not have a right to terminate services
 - Address interruption of services
 - Rent abatement (rare)
 - Termination (even more rare)
- Building hours and hidden expenses (“excess usage”)
 - After hours HVAC, additional janitorial, additional electricity and water
 - Tenant should be responsible to reimburse only for actual costs incurred by Landlord

Key Lease Terms (Cont.)

- Maintenance and repair
 - Landlord: building structures (including roof), building systems and common areas
 - Tenant: premises only (good condition ordinary wear and tear excepted)
- Alterations
 - Obtain right to make non-structural, interior or decorative alterations without consent or with reasonable consent
 - Limit obligation to remove alterations and restore at end of term to situations in which Landlord requests restoration at the time it approves the alterations
 - Limit or eliminate management or supervisory fee charged by Landlord for “monitoring” alterations work

Key Lease Terms (cont.)

- Assignment and Subletting
 - Permit use by consultants and others (i.e. office sharing)
 - Permit transfers to affiliates and successors
 - Landlord approval not to be unreasonably withheld
 - Recapture rights (try to limit or delete)
 - Landlord right to retain all or some of any profits
 - Continuing tenant liability
- Insurance
 - Tenant insures its property and also insures against claims of third parties occurring on its premises (avoid business interruption insurance)
 - Landlord insures against damage to building, third party liability occurring in common areas
 - Tenant's insurance agent should review
 - Waiver of Subrogation -- each party looks only to its insurance for claims and cannot sue the other even if the damage or liability is caused by negligence of the other

Key Lease Terms (cont.)

- Casualty
 - Termination right if premises is not restored within a specified time frame
 - Time period for repair or replacement
 - Rent abatement while premises remains unusable
- Condemnation
 - Termination rights
 - Condemnation awards (tenant not entitled)
- Subordination, Non-Disturbance and Attornment (SNDA)
 - Lease subordinate to rights of existing and future lenders (*Generally required by lender and non-negotiable*)
 - Lender can foreclose if landlord is in default and can terminate the Tenant's lease
 - Tenant's subordination should be conditioned on non-disturbance
 - Non-disturbance: if Tenant is not in default under the lease, then lender (new landlord) will not terminate the lease
 - Attornment: Tenant consents to lender or successor as new landlord

Key Lease Terms (cont.)

- Default
 - Tenant needs notice and cure rights
 - Remedies include termination, reentering premises, all rents to end of term
 - Landlords usually object to an obligation to mitigate
 - Generally no landlord default provisions
- Holding Over
 - Purpose is to ensure Tenant timely vacates space
 - 150% to 200% of prior year's rent is typical (usually includes additional rent)
 - Holdover rent should be exclusive remedy; specifically exclude consequential and punitive damages

Key Lease Terms (cont.)

- Security Deposits
 - Reachable only if there is an “Event of Default”
 - Reduced over time
 - Returned at end of term
- Initial Alterations and Work Agreements
 - Tenant allowance
 - Additional allowance as alternate means of financing initial improvements (likely a high rate)
 - Identify architect and contractor
 - Time frames
 - Punch list and acceptance of space prior to occupancy

Contraction and Early Termination Options

- **Contraction Option**
 - Ability to give some space back to Landlord during the term (one-time or ongoing)
 - Landlord will require payment of a fee (certain amount of rent, reimbursement of unamortized allowance and brokerage fees)
 - Costs for separately demising the returned space
- **Early Termination Option**
 - Ability to terminate early (one-time or ongoing)
 - Fee
- **Easiest to negotiate for these options at the Letter of Intent Stage**
 - Tie to an ascertainable metric or the occurrence or non-occurrence of an event

Subleasing

- Structural Differences (vs. direct leasing)
 - Contract with existing tenant (your sublandlord)
 - Subject and subordinate to the prime lease
 - Requires consent by prime landlord
- Pros
 - Lower rental rate
 - Potentially more bargaining power
 - Lower negotiating costs
- Cons
 - Subject to all terms of the prime lease
 - Terminates with prime lease (unless prime landlord agrees not to disturb)
 - Sublandlord typically unsophisticated on leasing/subleasing matters
 - No privity with or recourse against prime landlord (the provider of services)
 - Typically a smaller allowance
 - Approvals required at two levels (sublandlord and prime landlord)

Obtaining Early Termination Mid-Term

- Landlord (and market) specific outcome
- Landlord's Motivation: Maximize realized rental!
- Tenant's Strategy
 - Best to discuss with an attorney prior to approaching Landlord (avoid unintended consequences)
 - Demonstrate imminent default (share financials, give evidence of loss of contract/grant, etc.)
 - Actually default
 - Offer substantial termination fee (i.e. not just security deposit)
 - Depending on Tenant's mission, argue hardship
- Other considerations
 - Release of liability (conditioned on Tenant's timely vacation)
 - Sublease some or all of premises instead of seeking to terminate

Work Agreements/Tenant Build-Out

- Design Process
 - Tenant's architect/Landlord's engineers
 - Landlord approvals
- Construction
 - Landlord v. Tenant
 - Landlord's management fee
 - Timing/delays
 - Operating expenses during construction
- Tenant Improvement Allowance
 - Costs in excess of allowance
 - Use of allowance for tenant installations, furniture, moving and possibly rent

Upcoming Events

- **Next *Insights for Nonprofit Organizations* Breakfast**
 - **Topic: Cybersecurity for Nonprofits**
 - **Thursday, June 25th – 8:00am**
 - **Speakers will include:**
 - *Kenneth Chernof, Partner, Litigation, Arnold & Porter*
 - *Troy Pearsall, In-Q-Tel, Inc*
 - **In-Person at Arnold & Porter's Washington, DC Office**