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How Commercial Landlords Become Evil

Commercial leases are the "tail that wags the business dog." And, often they are unreasonably nasty. A commercial lease typically runs 45 pages or so. If the leases were just about renting the space, they could be two or three pages.[1] The rest of the lease is used to shift the risk of tenancy from the landlord to the tenant. Any contract assigns risk, and many agreements are negotiated without the parties realizing this contract function. But some landlords and their leases go beyond the ordinary in the provisions they include and ask the tenant to accept. Here are some examples.

1. Acceptance of the Premise "AS IS." Tenant is asked to accept the space "As Is." What makes this egregiously unfair is that much of what the Landlord is asking the tenant to accept cannot be seen by the tenant, e.g. building systems, underground pipes and wiring. Presumably, the landlord would not buy a car on those terms but thinks nothing of asking the tenant to take that risk on a ten (10) year lease. (And on which Premises the Tenant may spend $200,000 in buildouts.) To be fair and reasonable the lease should contain a "latent defects" clause holding the landlord accountable for defects for some period of time, say one year, from the commencement date of the lease.

2. The Relocation Clause. If the tenant signs a lease with a relocation clause the landlord may move the tenant to another space in the shopping center.[2] The landlord builds out or readies the alternative space and pays for the move. But this does not change the fact that the tenant has signed for one thing and is getting another. If the tenant decided upon, bargained for and signed a lease for the space on the corner or "main drag," it is not fair to move them to a location they do not even now about in

[1] For example, "X Property Co., the Landlord hereby leases 1500 square feet of the XX Shopping Center having a street address of 123 W. Street (the 'Premises") for a period of two (2) years at the rate of $13.00 per square foot per year payable in the amount of $this amount per month." Tenant accepts the Premises AS IS except that landlord warrants that the Premises shall be free of latent defects (i.e. defects a reasonable inspection would not reveal) for a period of one (1) year. Landlord shall be responsible for the roof, structure and building systems, tenant shall be responsible for its pro rate share of the common area charges (CAM). Tenant shall be in default of this Lease if it fails to pay the monthly rent within five (5) days of written notice that the rent is due or fails to cure some other Tenant obligation within ten (10) after receiving written notice of same. Upon default the Landlord evict the Tenant and seek damages equal to the unpaid rent, the cost to lease and renovate the Premises for the next Tenant. Tenant may assign or sublet the Premises only with the Landlord's prior approval, which shall not be unreasonable delayed or denied. Tenant knowledges that any prospective assignee of the Premises must have the background and financial resources reasonably suitable for operation of the business thereon. Etc.

[2] Lately landlords have avoided using the word "relocation" but the in effect the result is the same.

advance, and which is probably not as good as the current space. Otherwise, the landlord would not be moving the tenant to accommodate a new, more important, tenant. Basically this is a scheme of "bait and switch" unknowingly approved by the tenant.

Chances are that when the lease is signed the tenant does not appreciate the significance of this relocation provision or the possibility that it will happen. I had a client whose landlord invoked the relocation clause the first week. The tenant had just completed the buildout of the premises, its "fixturization," etc. and was told to move from the corner to the back of the strip center. That is when the tenant called me.

3. The Recapture Clause. Commercial property landlords and their tenants see two sides of the elephant; that is, present income today versus future wealth. The landlord sees the need to maintain the quality of the tenants and the building as a business. The tenants want to build a business on the premises, to build wealth. For retail tenants the value of the business can be tied to the location. For this reason the business-owner tenant invests substantial time, labor and money in the business. The business on the premises may constitute most if not all of the tenant's net worth and savings, not to mention dreams for the future. If the business owner tenant cannot sell the business, it can lose all of these things overnight.

And this is exactly what the recapture clause does. It says that if the tenant wants to assign the lease -which would be incident to a sale of the tenant's business operating on the premises – the landlord can, in its discretion, take back the space. If the tenant has not done well and a prospective buyer of the business (who would be an assignee on the lease) does not meet the landlord's reasonable qualifications (discussed below), then the recapture of space might have some rational basis. But what if the tenant has done reasonably well? What does recapture do to the tenant/business owner's business? It destroys it. And with it, it destroys the income and retirement savings of the tenant. The landlord just sees the space as a source of income, but the business owner/tenant may have most of its investments, net worth and savings tied up in the business. Virtually all business owner tenants see the business as something being built for the future that they can sell or pass on to their heirs.

4. Assignee Qualification Clauses. In most leases the landlord makes an assignment of the lease (i.e. transfer of premises from the present tenant to a new tenant), if it allows it at all -- see recapture clause above – subject to the prospective assignee's, i.e. replacement tenant's, qualifications. If not carried to extreme this makes sense. The landlord should not have to accept a bad tenant just because the present tenant wants to

sell its business, and as part of that, assign the lease. And it is not good or fair to the present tenants to have a "dud" next door.

However, some leases go overboard on their requirements. The lease may state that the assignee (i.e. prospective tenant) must have (a) the same or comparable net worth and financial resources of the existing tenant, and (b) the same managerial knowledge and experience as the present tenant. But think about it. Why would someone with the financial resources and net worth equal to or greater than the tenant's buy the tenant's business? Would they not want to operate at a higher level? Many owner-operated businesses are the fulfillment of a dream to get started, or a case of trading up to the next level of business success. A prospective tenant with the knowledge, experience and net worth equal to or greater that the existing tenant is probably going to go to the next level, e.g., buy what the existing tenant wants to buy, not stay equal.

(a) Knowledge and experience. The application of these knowledge and experience requirements can get ridiculous. For example, the firm had as a client a C-suite executive who was a millionaire several times over and with high level management experience. Still, the landlord initially rejected the client as a tenant to buy and operate a game shop. Reason eventually prevailed and the client got the space, but knowledge and experience should never have been an issue. (If I wanted to be snide, I would say that the prospective tenant probably had knowledge and experience greatly exceeding, and several levels higher on the corporate ladder, than the landlord's lease manager. Such are the things encountered by tenants and their attorneys.)

(b) Net worth and financial resources. And, on more than one occasion my client could not sell a restaurant as a going concern because the landlord would not accept the buyer, even though the buyer was already in business. The result of the landlord's refusal was that my client had to sell the equipment and furniture at an auction. No income or worth was reserved for the future.

The end result of exceedingly arduous assignee-tenant requirements is that chain stores, owned by corporate-America, may be the only tenants who qualify.

5. <u>Building Structure Expenses as CAM Charges</u>. It used to be that there was a bright line between the landlord's duty to take care of the roof, structure, and building systems on the one hand, and the tenant's responsibility to share in the common area and maintenance expenses, like cleaning, security, the repair and maintenance of the building's interior on the other. But these days landlords are becoming increasingly adept at dumping all or most of their structure and building system repair, maintenance, and replacement expenses into the CAM charges. The result is that the tenants pay the

landlords' expenses as pro rata add-ons to the rent, i.e. "Additional Rent." Unless the tenant is buying the building under a "lease-purchase" agreement – in which case the tenant would eventually benefit from improvements as the owner – it is not fair or reasonable for the tenant to pay the landlord's repair, maintenance, and replacement operating expenses.

6. The UCC Security Interest. Honorable mention to the "Parade of Horribles" listed above is a provision in the lease granting to the landlord a UCC security interest in the tenant's furniture, fixture, equipment, inventory and other personal property ("goods") on the premises. The security interest is a form of lien and allows the landlord to seize the assets in the event of default. "UCC" stands for the Uniform Commercial Code which governs the sale of goods and the pledge of same as collateral.

The UCC security interest is unnecessary in some states, like Arizona, which by state statute have a strong landlord's lien. In Arizona the landlord's lien attaches to the goods when the lease is signed and is triggered by the tenant's default. In Arizona the lien attaches even to goods that do not belong to the tenant. This can result in a meeting with the constable or sheriff to determine which goods should be released. Adding a UCC security interest to the landlord's lien in Arizona is "belt and suspenders" security for the landlord.

In some states the landlord's lien is less effective. For example in Texas the landlord's lien is automatically perfected without any filing requirements at the beginning of each 12-month period. This is good except that the landlord's lien will lose priority with respect to any other security interest on the tenant's personal property perfected during the preceding 12-month period. The effect of the Texas statute can be to negate the landlord's lien as a form of security because during the preceding 12-month period the tenant could pledge the goods as collateral for a loan with a bank or other lender and that loan-related lien would have priority over the landlord's lien. For this reason the Texas landlord may want the UCC security interest in addition to the landlord's lien.

But what the Texas landlord may consider to be a defect in the Texas landlord's lien is exactly the reason why an Arizona tenant should not grant a UCC security interest in the goods on the premises: the lien may prevent ordinary course of business inventory or equipment financing. An Arizona lender is not going to accept its UCC security interest in the new goods (e.g., inventory or equipment) being behind, i.e., having lower priority than, the landlord's security interest. Thus, the tenant must ask the landlord to subordinate its lien. Landlord's typically do so, but that is not the issue. The issue is:

Why should the business owner or its bank have to ask the landlord to approve its financing? The answer is: "It shouldn't."

Worse, granting a UCC security interest to the landlord may breach the terms of existing loans or equipment leases which may prohibit or require the lender's approval of additional liens on the personal property. In a nutshell in Arizona granting a UCC security interest to the landlord interferes with the tenant's ability to do business.

7. Last Comments; the Lesson Learned. These are not all of the bad provisions in, or bad things that can happen because of, a heavy-handed commercial lease. But from this brief discussion you can see that the commercial lease truly is the "tail that wags the business dog."

Good luck in your business venture!

Law Offices of Donald W. Hudspeth P.C.
Ph 602.265.7997
Web site www.azbuslaw.com