

## Poorly drafted leases can cause headaches for tenants and landlords

These 10 common problem areas can easily be avoided by paying attention to details



### GUEST COMMENTARY

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It's a dangerous world out there. We cannot eliminate all risks. But a well-drafted lease can minimize risk, and a poorly drafted lease can unnecessarily create serious problems for either a landlord or a tenant. Following are instances in which a serious problem would not exist but for a poorly drafted lease.

#### Unexpected operating expenses

Leases often require a tenant to pay its pro rata share of "operating expenses." Such clauses are often drafted broadly to include all costs of owning and operating the property and may obligate a tenant to pay a share of significant cost items, such as environmental cleanup costs, insurance deductibles upon damage to the property, and the cost of capital expenditures to improve the property. Regardless of whether the tenant's pro rata share is a few percentage points or 50 percent or more, a tenant will not want to share in these costs.

#### Compliance with law

Most leases require the tenant to comply with applicable law. Some are phrased in such a manner that they obligate the tenant to make improvements to the premises required by applicable law. More than one tenant has been shocked to discover that it is obligated to make expensive capital improvements, such as seismic upgrades or compliance with the Americans with Disabilities Act.

#### Release of landlord upon sale

Many landlords assume that upon sale of the property they are relieved of all obligations under the lease. This is not the case unless the lease expressly provides to that effect. If the provision is not included, the property is sold, and the buyer fails to perform an obligation required by the lease, such as to construct tenant improvements, the tenant will have recourse against the original landlord.

Some leases provide that the premises must be restored to original condition. Such a clause requires the tenant to remove all improvements that were made by or for the tenant and return the premises to its original condition.

#### Condition of premises upon surrender

Leases generally provide that the tenant must surrender the premises in good condition at the end of the lease term. Some leases provide that the premises must be restored to original condition. Such a clause requires the tenant to remove all improvements that were made by or for the tenant and return the premises to its original condition. This could be an extremely expensive endeavor.

#### Waiver of subrogation

Every lease should include a mutual waiver of subrogation rights with respect to the insurers. If an appropriate waiver is not included, the insurer of the building, upon paying the landlord for the value of the damage suffered in a fire, is "subrogated" to the landlord's rights and may assert any claim that the landlord may have arising from the fire. If the fire was caused by the tenant's negligence, the insurer can sue the tenant to recover all that it paid to the landlord. Conversely, if an insurer of the tenant's personal property pays for a loss when the loss was caused by the landlord's negligence, the insurer may recover from the landlord the amounts that it paid to the tenant.

#### Outside the premises

A tenant should think beyond the four walls of the premises and consider whether it needs to use any amenities, such as parking and common-area conference rooms. Unless the lease directly grants the tenant the right to use such facilities, the tenant may find that they are unavailable when the landlord decides to convert the facilities to a different use.

#### Discount rate

Many leases provide that upon a tenant default, the landlord may recover all the rent for the entire lease term, discounted to its present value at a specified rate. Many tenants and even some landlords confuse this discount rate with an interest rate. In fact, the lower the discount rate, the more the tenant will owe. A tenant should always negotiate for the highest discount rate possible, and a landlord should always negotiate for the lowest discount rate possible.

#### Tax-exempt tenant

A 501(c)(3) tax-exempt organization may sign a lease that requires the tenant to pay the taxes, believing it will be exempt from paying the taxes. However, under Oregon law, the county tax assessor will reject the application for exemption unless the lease expressly states that the rent has been set at a level to take into account that the tenant is a tax-exempt entity and that all the benefits of the property being exempt from taxation will inure solely to the tenant.

#### Casualty damage to tenant improvements

Tenant improvements can often be very expensive, particularly in high-rise offices. Yet leases commonly fail to adequately address which party has the responsibility to insure the tenant improvements and to rebuild them upon casualty loss. A lease may provide that the landlord is responsible to rebuild the premises following casualty loss, which by its terms includes the tenant improvements. But the insurance the landlord carries may not cover the tenant improvements. Conversely, a tenant may assume that the lease requires the landlord to rebuild the tenant improvements and upon that assumption not obtain its own insurance, when in fact the lease does not so require.

#### Subordination and non-disturbance

Many leases provide that the lease is subordinate to any existing or future mortgage against the premises. From the tenant's perspective, this clause should always be coupled with a "non-disturbance" clause, which provides that so long as the tenant performs under the lease, the tenant's possession will not be disturbed. Without a non-disturbance clause, if the landlord defaults on its loan and the lender becomes the owner of the premises, the lender will have the ability to terminate the lease and evict the tenant. It will be able to use this right to extract a substantial increase in rental.

Both landlords and tenants can avoid danger by using an appropriately drafted lease. Money and time spent with an experienced real estate lawyer before signing a lease is money and time well spent.

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