



## Sample Lease

### **Evaluating the lease agreement**

There are many types of lease agreements and many terms and conditions within. Creating a lease and specific terms to best represent your client is fundamental aspect of property management. Use the sections that follow to further evaluate common terms used within lease agreements.



## KEY REALTY SCHOOL

# Evaluating Lease Agreements

From a property management perspective

### WHAT IS A LEASE?

A lease is a contract (written, verbal or implied) which transfers possession rights from an owner (lessor) to a tenant (lessee). While the tenant is entitled to exclusive possession during the term of the lease, the lessor retains title and reversionary rights to take possession at the end of the lease. Therefore, ownership never transfers in any type of lease. A lease is the only way an owner can legally profit by property ownership (during the ownership) if the owner does not use the property for his or her own business, agricultural or housing needs.

**See exhibit A**

### WHY IS A LEASE USED?

There are many benefits to a lease not often considered in the recent trends of Real Estate in the United States and particularly in Western States. One overlooked benefit is the security from a possible plummeting market. Tenants can most often secure a specific monthly payment without the threat of losing capital invested in a properties interest. This was especially true in the mid 1980's, where numerous homeowners bought homes only to find a 10 to 15% decline in the properties value within 2 years. If these purchasers could have predicted or foreseen the decline in the region, a residential lease might have been a better option.

Leases are also often used by prospective owners that cannot qualify to purchase or are uncertain about a potential purchase of a property. Leases provide the balance for housing that is needed for those who don't wish to own at a given time.

**See exhibit A**

### VALIDITY OF THE LEASE:

The statute of frauds mandates certain contracts be in writing. The contract must be signed by the person who is being held to the contract. This statute includes leases for more than one year. Therefore, oral leases one year or less need not be in writing and many are not. Though some leases may be verbal or implied it is extremely difficult to enforce aspects and terms of the lease without a written and signed contract to confirm all parties awareness of these terms.

**See section 31 and signature block of exhibit A**

## ORAL LEASE EXAMPLES AND CONDITIONS:

An oral six-month lease, which could ordinarily be enforceable, would be unenforceable if it were not to commence for seven months. By the terms of such a lease, it would take more than one year for full performance (13 months).

An oral lease that continues or automatically renews after 12 month would be unenforceable after the 12 month period unless a period existed without any oral terms of the lease.

By setting forth terms as a written contract the owner or manager is protected against a situation where the lessee claims the verbal agreement was different from the actual agreement. Both parties are protected by written contracts because people tend to have fitting memories and remember agreements in a manner favorable to them.

### Types of Leases:

#### ESTATE FOR YEARS

The **estate for years** is the most common type of leasehold interest in real property. It is actually any estate created for a fixed period of time and need not be for even one year.

- The term must be certain
- No notice is required to terminate
- No maximum duration

**Note: The Statute of Frauds requires "a lease for more than one year must be written."**

A majority of American courts have also held that the **fixed term** and any **option periods** are added together; if the total exceeds the statutory period a written lease is mandated.

#### PERIODIC TENANCY

**Periodic tenancy**, commonly known as week-to-week or month-to-month or year-to-year is a tenancy which continues from one period to the next automatically, unless either party terminates it at the end of a period, by notice, which is usually the length of the rental period.

- Distinguished from tenancy for years
- Creation of periodic tenancy
- Arising from holdover

## GROSS LEASE

A gross lease is a lease where the landlord agrees to be responsible for all expenses which are normally associated with ownership of the leased premises, such as maintenance (includes utilities and repairs), insurance, and taxes. A tenant to a gross lease is only responsible for paying the monthly lump sum base rent and the landlord is responsible for operating the building and all other costs associated with the premises. The tenant's base rent usually includes the building operating costs. Today, a gross lease is very rare.

## NET LEASE

A net lease is a lease where the tenant has primary control of the premises and agrees to be responsible for some or all of the operating expenses of the premises, such as utilities, repairs, insurance, or taxes. A tenant who has a net lease is responsible for paying the monthly lump sum base rent as well as some or all of the operating expenses.

### Types of Net Leases

Net leases define the responsibilities of the landlord and the tenant differently. The following are types of net leases:

- **Single Net Lease** – A single net lease is a net lease where the tenant agrees to pay a monthly lump sum base rent as well as the property taxes. The landlord is responsible for all other operating expenses of the premises.
- **Double Net Lease (NN)** – A double net lease is a net lease where the tenant agrees to pay a monthly lump sum base rent as well as the property taxes and the property insurance. The landlord is responsible for all other operating expenses of the premises.
- **Triple Net Lease (NNN)** – A Triple net lease is a net lease where the tenant agrees to pay a monthly lump sum base rent as well as the property taxes, the property insurance, and the maintenance. Under a triple net lease there are a few legal defenses which may relieve a tenant of his responsibilities. For example, a triple net lease may relieve the tenant of his responsibility if the property is subject to an eminent domain proceeding.
- **Absolute Triple Net Lease (Bond Lease)** – An absolute triple net lease is a net lease where the tenant agrees to pay a monthly lump sum base rent as well as the property taxes, the property insurance, and the maintenance. Under an absolute triple net lease there are no legal defenses if a tenant fails to meet his responsibilities.

## PERCENTAGE LEASE

### What Is a Percentage Lease?

A percentage lease is a lease where rent payments are based on the lease holder's sales or profits. A typical percentage lease will have a base rent, or minimum amount of rent that is due each month. In addition to the base rent, the lease holder must also pay a percentage of the gross or net sales each month, as stipulated in the lease agreement. The lease should state exactly what counts as a "sale" to be included in the calculation of what rent is due.

## GROUND LEASE

A GROUND LEASE is a lease of land only and is also commonly referred to as a land lease.

At the end of the lease, the lessor gets possession of the property and generally the improvements placed on the property by the tenant. Many of the free standing sites in shopping centers, such as those pads for fast food restaurants, are ground leases. The tenant puts up the building and is responsible for all improvements. The owner keeps title to the property and pays no capital gains taxes, although the owner is taxed on the rent collected.

Ground leases are usually net leases where the tenant pays taxes as well as all other expenses. They may also have a percentage of the rent feature where they include a percentage of the gross in addition to the net amount. This may be in conjunction with a Consumer Price Index (CRI) feature of the net lease. The CRI and the additional percentage serve to give the owner protection against inflation.

Many large chains like ground leases since they avoid tying up huge sums of cash in land. Another advantage is that some owners will accept a much lower rent than the cash value of the land would normally dictate because they realize that they are going to own the tenant's improvements at the end of the lease.

As an example, it is hard for an owner of land worth \$2,000,000 to turn down a net lease offer of \$90,000 a year when the owner will not only get back the property in 20 years, but will own the improvements as well. In addition, the appreciation in value will belong to the owner who did not have any taxes or other carrying costs until that point in time. After 20 years, the owner knows that he or she can sell the property, lease it to others or lease it to the original lessee from a position of great strength.

## ASSIGNMENT

An assignment is very similar to a sublease, except the new tenant takes on the rights and obligations of the entire lease, not just for a limited amount of time. In the case of an assignment, there is usually a contract between the new tenant and the original landlord, where one was lacking in a sublease. The original tenant is usually still liable for all the obligations of the original lease until it runs out.

## SUBLEASE

A sublease, or sublet, is a contract between a pre-existing tenant and a new tenant. For example, tenant A may have a lease with landlord X, but A subleases the rented property to tenant B through a contract. Generally, the new tenant takes on all the rights and obligations of a normal tenant, but for a limited amount of time. The original tenant is still liable for all the obligations of the original lease until it runs out.

## USE OF STANDARD FORMS

A property manager should not attempt to modify standard clauses in a lease, prepare new clauses or prepare complex leases by the cut-and-paste method utilizing clauses from other leases. First of all, it exposes the property manager to liability should his or her draftsmanship create results not

contemplated that work to the detriment of the owner.

Secondly, preparing a lease using other than what is regarded as a standard industry lease could be construed as the unauthorized practice of law. While there are a great many standardized lease forms covering commercial and industrial properties, if any lease form is to be materially altered or a new lease drafted, competent legal counsel should be sought.

A point to remember is that lease ambiguities are generally resolved against the party drafting the lease. Therefore, it behooves the property manager to make certain that the lease is clear. If a lease form includes a clause you do not understand, see an attorney; don't take chances. Leases often have clauses specifically related to attorney fees that may arise because of the terms within the lease.

**See section 23 of exhibit A**

#### LEASES PREPARED BY LESSEES

You should be on your guard when a tenant or tenant's attorney has prepared a lease on a form you are not familiar with. While it may appear clear, you should protect yourself from liability by having the lease reviewed by an attorney. The attorney should also review your customary lease form so that any differences can be noted.

Some will also include a form number. Unfortunately, some people will use this technique to try to take advantage of the other party

You do not want to be a party to any deception. Even if the lease was prepared by your client, you want to make certain the tenant fully understands the lease provisions, especially any unusual provisions in the lessor's favor. You may wish to suggest to the lessee that he or she also have the lease reviewed by an attorney.

Let the market dictate the use of non standardized forms. If the demand for property is down, the property manager may be more inclined to accept the terms of a lease prepared outside of the traditional and standard lease on file.

#### CONTRACTS OF ADHESION

An adhesion contract is a standardized agreement. Adhesion contracts are on a "take it or leave it" basis. If you don't agree to the terms of the contract, you cannot acquire the products or services. There is no opportunity for negotiation regarding any terms in the contract.

#### UNDERSTANDING POSITIONS AND EXPECTATIONS

When negotiating a lease, as an agent of the lessor you want to make the best deal possible for your client. The tenant and/or the tenant's representative wants to make the best deal possible for the tenant.

Each party is likely to have an opening position advantageous to them as well as an idea as to how low or how high they can go.

Each party has motivating factors that are not apparent to the other party as an example, buyers who

have purchased property will often reveal that they would have paid more if they had to and sellers in the same transaction have revealed that they would have accepted less.

When you experience many vacancies and/or there is competition in the marketplace from similar property that has been vacant for some time, the tenants have a great deal of leverage in negotiations. Sometimes tenants don't perceive this power and fail to use it. On other occasions, they assume that they have leverage power when in actuality they do not. If the negotiations are to be successful, this perception of power has to be deflated.

An example of deflating the tenant's perception of power would be in negotiating a lease extension. If the tenant believes you need the tenant more than the tenant needs you, then the tenant might demand a reduction in rent for a lease extension. You might be able to reduce the tenant's expectations by notifying the tenant that you will be showing the premises to a prospective tenant. Always use a real person interested in the rental you will be showing. A tactic like this can change a current tenant's attitude.

In a market situation where there is a very low vacancy factor for similar properties and you have several prospective tenants, it is a lessor's market that is advantageous to your client. Nevertheless, in preparing for negotiations you should determine:

1. What you want;
2. What you must have;
3. What is not too important?

You should consider the market to determine what you want. You must consider the supply and demand features of the marketplace. If a particular tenant is important to you, you must consider the fact that too high a rent will mean a marginal or loss operation.

## RENT INCENTIVES

Owners like to show high rents to bankers for refinancing as well as to prospective buyers when they wish to sell and to establish a base rent in the event of subsequent rent control.

Rental concessions should be considered for several other reasons. If you are taking over a new structure or one that has recently been rehabilitated, you would want to stabilize the structure (fill vacancies) as soon as possible. This could eliminate a negative cash flow for the owner, Rental concessions can give you an edge on the competition.

Rental concessions might be absolutely necessary if the rent being asked is more than market rent for similar available properties. Rental concessions can take several forms:

An effective variation on free rent is to offer it to your present tenants. As an example, offer one month's free rent if the new tenant can bring in someone else to lease a unit. Since the tenant does not get a rental incentive, he or she is less likely to move when the lease expires.

## LEASE RENEWALS

Because of the bother and costs associated with moving, a tenant will generally be willing to pay a premium over comparable vacant units to remain at a location.

A rent increase from five percent to ten percent, even though not indicated by market conditions, will generally be accepted by a commercial tenant. However, you could end up with a vacancy if you get too greedy.

You want to make the increase seem reasonable rather than arbitrary when you offer a tenant a new lease at a higher rent. As an example, you can show cost increases such as taxes and insurance as the reason. There is always some rise in costs.

You might be in a situation where you have several vacancies and a commercial tenant needs a downward adjustment in the rent to survive. Rather than lowering the rent, offer to defer a portion of the rent. As an example, instead of paying \$1,800 per month rent, a tenant may pay \$1,000 per month and sign a note for \$9,600 for the balance of the one-year lease. You haven't reduced rents and there is a possibility that the tenant will recover financially and make good on the note. Later if the tenant is able to pay the full rent you have the tenant pretty well locked in until the arrearage can be paid off.

## RECORDING LEASES

If a lender made a loan on a property where a tenant was in possession, a foreclosure of the loan would leave the lender owning the property subject to the lease rights of the tenant. However, if the lease had been signed but the tenant had not yet taken possession of the property, a lender would not have constructive notice of the tenant's rights. So a later foreclosure of a loan could leave a tenant subject to eviction by the foreclosing lender.

## DISCLOSURES

If a property manager knows that a property is unsuited or cannot be used for the intended purpose of the prospective tenant, then the prospective property manager must disclose this information. As an example, an intended use might be prohibited by zoning or restrictive covenants. Disclosure would be required if the property manager knew of these restrictions. Similarly, the property manager should disclose any negative information he or she possesses which a prospective tenant would want to know.

Other disclosures are mandated by state statutes in addition to those mentioned above. These types of disclosures might include the following. The more written disclosure that takes place, the better position the property manager is in if any instance of material fact were to arise.

Use the Generic Residential Lease Agreement attached to correlate information supplied in this section. (Exhibit A)

## Section 2

### Item 3

Damage Deposits have recently become a large area of concern within leases completed in the Western United States. It is recommended that a clause is added pertaining to the determination in



cost of such damages occurring during the duration of the lease. Such as: A dated video recording of the properties current condition is held on file with the lessor or property manager. The lessor may employ the services of a licensed contractor to determine what if any damages were caused by the lessee throughout the duration of the lease.

Providing video proof of a properties condition has become much less costly within the last five years. Property Management companies can easily tally a properties current condition through video and time stamp the file with today's technology. This method provides a reliable source for expected repairs and even more so for the catastrophic loss such as structural interior modification. This allows for little to no interpretation of the item 5 within this same section.

#### Item 12

This maintenance section should include a clause pertaining to the lessees ability to complete maintenance on the property through the use of subcontractors not approved by the lessor.

Example: The lessor does not authorize lessee to order or complete any maintenance or repair to the property without the expressed written consent of the lessor. The lessee is financially responsible for any service ordered by the lessee. The lessor assumes no responsibility for services ordered by the lessee. The lessor may use deposit moneys initially supplied by the lessee to pay any outstanding debt of any service not paid but ordered by the lessee.

#### Entire Agreement

The terms of a lease should be subject to modification. Instances arise throughout the practice of Property Management that call for future lease modification. These modifications are best enacted when the modification occurs through amendment or addendum to the lease. Though the addendum should be thought out and approved for legal use by a licensed attorney, the integrity of the original lease is not affected unless the addendum contradicts an item within the original contract.