

Commercial Leases: A Few Points to Ponder

By Thomas A. Neufeld

Besides finding an acceptable tenant for its space, a landlord must consider many matters in negotiating the lease, some of which are discussed below.

Measurement of the Space

The annual fixed rent is commonly described as an agreed-upon rate per square foot, and the determination of the area of the leased space will have financial implications. Landlords will include a portion of the building's common area in order to establish the "rentable square feet." Tenants will focus on the "usable square feet" within the four walls of the leased space. Because the rent will be calculated on the rentable square feet, tenants need to know the loss factor to determine the real cost per usable square foot. Of course, other considerations, such as the layout and utility of the space, are also very important to the parties. For new leases and even for renewals of existing leases, a landlord may be able to increase its rental income through an updated, accurate re-measurement of the leased space.

Escalations

Commercial leases typically require tenants to pay for all or a proportionate share of real estate taxes and operating expenses, or at least the escalations in those items over the base amounts. The landlord and tenant must carefully review the components of those escalations. A broad definition of real estate taxes that includes water charges, sewer rents, assessments, business improvement district and similar charges will yield a greater rental income to the landlord. Similarly, an expansive list of operating expenses, which may, for example, include the cost of certain capital improvements, will increase the landlord's rental income. Given the recent dramatic increase in insurance costs, a landlord may require a tenant to pay all or a portion of the landlord's insurance costs.

Electricity and HVAC

All tenants pay for electricity one way or another. The rent-inclusion basis is easy to administer, and it is the method

Leveraging Air Rights to Finance Construction

By James P. Cullen and
Lawrence J. Bartelemucci

As the amount of available land upon which to build decreases, landowners and developers often find themselves searching for new and innovative ways to maximize the value of their properties. It is ironic, then, that one of the most innovative, yet underutilized, methods of maximizing land value is not new at all. For over thirty-five years, the New York City Educational Construction Fund ("ECF") has maximized the value of many New York City sites by simply leveraging the value of the air rights over those sites to fund the construction of city schools as part of combined-occupancy structures.

In the ECF model, ECF issues a long-term lease to a developer for an "envelope of space" above a site that it owns or was conveyed to it by the City of New York. The developer then funds and constructs the non-school portion of the building within that envelope of space, while paying rent to ECF over the typical 75-year term of the lease. Non-school uses for ECF projects have included a large office building, a communications technology facility and both luxury and

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subsidized housing. ECF then utilizes the rental income received from the developer to secure the financing for the construction of the school portion of the combined-occupancy structure. The developer is also responsible for the actual construction of the school portion, based on approved plans and an agreed price.

Once financing is secured and the building complete, the rental income from the non-school portion is used to pay off the construction debt for the school portion. At the end of the non-school portion lease, the envelope of space and existing building become the property of the landowner. In some cases, the rental value of the air space exceeds the debt service for construction of the school. In other cases, the rental income is less than the debt service for the school construction cost, and surplus from another ECF project can be utilized to make up the shortfall or the city can cover the shortfall in its lease of the school. Any rent paid by the city for the school will be far less than the cost the city would have incurred to build the school itself. The school lease extends for the term of the school construction bonds, which have a 40-year amortization period.

This arrangement creates a win-win situation for both the landowner and developer. The landowner in ECF's position obtains its space at much less cost than if it was constructed as a free-standing structure, and may even obtain it at no net cost. Moreover, the leasing of the air rights allows the landowner to tap an income source that would otherwise not be available, and the developer avoids the up-front cost of land acquisition (which often comprises twenty to twenty-five percent of development costs). This twenty to twenty-five percent savings of early development costs can be essential to developers, as financing is normally difficult to obtain or may not be available for land acquisition. In addition, the developer often has a relationship with the

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most desirable to a landlord if it results in a profit over the landlord's cost of electricity. The landlord should reserve the right to increase the rent if a subsequent survey indicates excessive use of electricity by the tenant. If the electricity is submetered, it is common for the landlord to impose a surcharge above the utility company's rates, although the surcharge is often less than what the landlord can achieve through the rent-inclusion method. The method most beneficial to a tenant is the direct metering of the tenant's electricity service. However, even a direct meter may provide a cost-savings to the landlord if, for example, the electricity for the heating, air conditioning and ventilation equipment servicing the leased premises is provided through the tenant's meter.

Alterations

The scope of the landlord's workletter, the timing and amount of the rent concession, and the landlord's contribution toward the cost of the tenant's qualifying work must be carefully considered. In order to reduce its up-front investment in the leased premises, a landlord may be willing to accept a lower rent if the tenant assumes the credit risk of building out the space. Alternatively, a landlord may provide some work-related concessions in order to maintain a higher rent roll so as to satisfy the requirements of an existing or prospective lender, investor or purchaser. Tax and insurance issues are involved in these decisions. To preserve the integrity and value of the building, the tenant's alterations must be subject to the landlord's consent. The tenant's alterations raise other concerns, such as the abatement of asbestos, lead paint and other hazardous materials, and compliance with applicable laws, including the building code, fire code, the Americans with Disabilities Act, and New York City Local Law 58 or the like. For the landlord to avoid a costly demolition expense, the landlord may require the tenant to remove its alterations at the end of the lease term.

Maintenance and Repairs

Usually a landlord is responsible for the structural and public portions of the building (except in a net lease situation), and the tenant is responsible for maintaining the leased premises and the fixtures therein. The lease can specifically make the tenant responsible for the maintenance of dedicated HVAC equipment and electrical or water meters. The lease should provide for the parties' respective obligations regarding any existing or new sprinkler system and any modifications thereof. The tenant must comply with laws, although the tenant may

seek to limit that obligation to those matters arising out of the tenant's particular use of the leased premises.

Assignment and Sublease

The lease must spell out under what circumstances, if any, the landlord will consent to an assignment of the lease or a sublease of the premises. The factors include the identity and creditworthiness of the proposed assignee or subtenant and its proposed use of the space. The landlord should retain the right to recapture the leased space in order to take advantage of market conditions or to accommodate other tenants. If the landlord does not recapture the space, all or a significant portion of any profits derived by the tenant from the assignment or sublease should be paid to the landlord.

Financeability

An overriding concern affecting many of the provisions in a lease is whether the provisions will be acceptable to the landlord's mortgage lenders. The income stream from the property must remain uninterrupted under all circumstances. The tenant must not be permitted to setoff any claims against the rent payments. The lease must be subordinate to existing and subsequent mortgages. The landlord's lender must be given the opportunity to cure any lease defaults by the landlord before the tenant seeks any remedies. To avoid the loss of a valuable tenant upon a foreclosure of the landlord's mortgage, the tenant must agree to attorn to the lender or a successor landlord. The lease must provide that the lender will not be responsible for the acts or defaults of the foreclosed landlord. The tenant must provide to the landlord or its lender an estoppel certificate certifying the status of the lease. The prescribed insurance must be maintained by the tenant. The lease should allow reasonable modifications required by the lender so long as the tenant's obligations or rights are not materially affected.

Conclusion

A landlord must carefully scrutinize the many provisions of its lease in order to enhance its net income and to limit its liability. ■



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general contractor selected to build both portions of the combined occupancy structure, and can derive additional income from the construction profit center.

The key to success, as in all real estate transactions, is the presence of valuable property in a desirable location. Local zoning laws must allow for mixed use buildings that enable the landowner and developer to "share" the real property.

The ECF model not only works well for municipalities or quasi-governmental organizations, but it can also work equally well for institutional owners, such as hospitals, universities and other not-for-profit organizations that are not developers themselves. Oftentimes, institutional owners can deliver attractive target tenant prospects for the leased portion of the structure. For example, doctors seeking medical office space on hospital-owned sites and research and development organizations that desire access to universities are ideal target tenants for developers of combined-occupancy structures.

This model allows such organizations increased flexibility and leverage to secure project financing. In addition, a landowner with multiple sites of varying attractiveness can pool the income from its more valuable sites to support those that are in less desirable locations.

The attorneys at Anderson Kill & Olick have considerable experience with the advantages of air rights development for governmental and non-profit entities. These attorneys are available to evaluate the air rights development model for sites owned or controlled by such organizations. ■

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Mark Your Calendar

Effectively Managing Your Real Estate Investment

Date: March 2, 2005

Place: The Harvard Club, 27 West 44th Street, New York City

Time: 4:15 - 6:00 p.m. (cocktail hour from 6:00 - 7:00 p.m.)

Anderson Kill & Olick, P.C. is pleased to announce that it will host a real estate seminar entitled "Effectively Managing Your Real Estate Investment" on March 2, 2005, from 4:15 to 6:00 p.m. (cocktail hour from 6:00 to 7:00 p.m.) at The Harvard Club, 27 West 44th Street, New York City. Topics to be discussed include:

- Property Insurance Issues and the Issues Being Litigated in 9/11 Coverage Actions
- Handling Expensive Surprises in Construction: Legal and Practice Considerations
- Managing Contaminated Property
- Current Trends in Insurance Coverage for Real Estate and Construction Exposures

This program qualifies for 1.5 credit hours of New York continuing Legal Education.

For more information or to register, please visit our website at www.andersonkill.com or contact Michele Elie at (212) 278-1318.

We hope you have found this issue of the *Real Estate & Construction Advisor* informative. We invite you to contact the department Chairs or the Editor, listed below, with your questions and/or concerns:

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