ISSUES AND CONCERNS FOR A NONPROFIT ORGANIZATION WHEN NEGOTIATING A COMMERCIAL LEASE

Stephen D. Millas, Esq. and Cristina Coronado, Esq., Orrick, Herrington and Sutcliffe, LLP

Introduction

Today's landlords and tenants in the tri-state commercial real estate market have become much more savvy in their approach to negotiating a lease for commercial space. Many of them recognize the important issues that arise in the first lease draft proffered by the landlord and understand how to argue their position in a manner that will result in the appropriate revisions to the lease. However, many of these prospective tenants and landlords want to avoid the time delay and costs involved in protracted negotiations. This is especially true for nonprofit organizations, which often have even less capacity to spend significant (if any) amounts of legal fees on lease negotiations.

The purpose of this article is to identify and address the primary areas of concern in the typical commercial lease. The parties' ability to successfully negotiate each of these areas will depend upon a number of factors, including: i) the economic climate in the locale of the leased premises, i.e., whether it is favorable to landlords or tenants; ii) the economic terms of the proposed lease, e.g., a longer lease term and rent that approximates at least market rates will increase the leverage that the tenant has in the negotiation process; and iii) the experience and capabilities of tenant's and landlord's counsel, as well as the desire of each to engage in or avoid protracted negotiations.

1. The “Commencement Date” vs. the “Rent Commencement Date”

The tenant will want to negotiate a rent-free period, particularly in situations where either the tenant or the landlord plans to make improvements to the premises prior to the tenant’s occupancy. In such circumstances, the “Commencement Date” will be a different date from the “Rent Commencement Date”. The difference between these two dates creates a rent-free period. Typically, the Commencement Date will be the date the lease is executed, while the Rent Commencement Date will be the date that is the earlier to occur of (i) a specified date or (ii) the date that the tenant commences business at the premises. This formulation of the Rent Commencement Date is typically more favored by landlords. Landlords will not necessarily object to the concept of a rent-free period to enable the completion of improvements, but will favor a Rent Commencement Date that is tied to “substantial completion” of the tenant’s improvements. This is particularly true in situations where the landlord is constructing the tenant’s improvements. In such situations, the landlord’s ability to expeditiously complete the work will result in an earlier Rent Commencement Date.

2. The Tenant's Alterations

The provisions in the lease that address the tenant’s rights to make alterations to the premises can be extremely onerous for the tenant and favorable to the landlord. While it is appropriate for the landlord to have sole and absolute discretion over alterations to the building systems and building structure, the landlord’s approval of all other alterations should be limited to its reasonable discretion. Moreover, the landlord should be required to respond to requests for plan and alteration approval within a specified time period and to specify the reasons for the rejection
of the plans or alterations. Following such rejection, the tenant should have the right to re-submit the revised plans and commence the process again. The landlord will want the tenant to assume responsibility for the preparation of plans and the construction of the alterations done by tenant. This responsibility includes ensuring that the plans and alterations comply with legal requirements, including, for example, fire and building codes, as well as ensuring that all required permits and certificates of occupancy are issued with respect to the tenant’s work.

3. Tenant’s Use of the Premises

The easiest way to define the tenant’s “permitted use” of the premises in the lease, is to simply state the tenant’s business as the permitted use. However, the tenant should consider the possibility of future assignments and/or subletting of the premises, and may, therefore, desire a broader description of the permitted uses to accommodate the business of its prospective assignees and sublessees. The landlord will want the right and flexibility to decide upon acceptable uses for prospective assignees and sublessees when those future tenants negotiate their lease transaction with the landlord. Accordingly, the landlord will want to be as specific as possible when drafting the permitted use clause. While landlord and tenant each have different aims, there is a workable solution. There are certain general uses that the tenant will want to include in the permitted uses provision to which the landlord should not object. For example, if the tenant’s use can be described as “office” use, then the landlord would not be unreasonable in denying the tenant’s request that permitted uses also include “any other uses permitted by law.” Similarly, the landlord would not be unreasonable in seeking to further limit the tenant’s requested (broader) permitted use provision by prohibiting any uses which conflict with other leases in the building or governmental codes and regulations, e.g., zoning or the building’s certificate of occupancy. Further, the landlord may want to limit the permitted use for a nonprofit tenant to ensure that the premises are only occupied by a nonprofit tenant particularly if it granted the nonprofit tenant significant concessions (financial and/or non-financial) in the lease. The tenant may object to such a limitation, however, since it will significantly limit the universe of potential assignees and sublessees.

4. Subordination of the Lease

The landlord’s ability to negotiate the provisions in the lease that specify the extent to which tenant’s rights under the lease are subordinate to existing and/or future mortgages and/or ground or master leases, will probably be subject to the discretion of the landlord’s mortgage lender or superior landlord, as the case may be. The landlord will want to make sure that it does not provide the tenant with such a tenant-favorable subordination provision that it discourages potential mortgage lenders from wanting to finance the property. Ideally, the landlord, and its prospective mortgage lenders, will want the lease to contain an unconditional subordination provision, which provides that the lease is subject and subordinate to any mortgages then or thereafter encumbering the property. Unless accompanied by a non-disturbance provision, the unconditional subordination provision permits the foreclosing mortgage lender to eject (the foreclosure equivalent of eviction, only better for the mortgage lender) the tenant, even if its lease is not in default. The tenant can protect itself from such a harsh result by having the lease provide that subordination of the lease and the tenant’s rights thereunder is conditioned upon the tenant’s nondisturbance right, or upon the mortgage lender’s delivery of an acceptable “Subordination, Non-disturbance and Attornment Agreement” (SNDA). By obtaining nondisturbance rights, either in the lease or in a separately negotiated SNDA, the tenant will ensure that, so long as it is not in default of the terms of its lease, it will not be ejected or evicted. Alternatively, and particularly in the case of a short-term lease, the tenant may be able to obtain an acceptable SNDA from the existing mortgage lenders/superior landlords prior to the execution of the lease, thereby obviating the need to modify the subordination provisions of the lease. This makes better sense in the case of a short term lease, since it is more likely (than in the case of a
longer term lease) that the existing mortgage will be the only mortgage that the tenant will need to be concerned with during the term of its lease.

5. Assignment/Subletting

The provisions in the lease that address assignment and/or subletting increase in significance in somewhat direct proportion to the length of the lease term and the size of the premises. To the extent that a tenant enters into a lease for a longer term or for a larger space than desired, the tenant will need to have flexibility to assign and/or sublet its space. This discrepancy can exist either at the inception of the lease or upon reconsideration at some point during the lease term. The ideal provision from a tenant’s standpoint is one that provides for the tenant to be able to assign the lease or sublet the premises without the landlord’s consent. Conversely, the landlord will want as much control as possible over a tenant’s ability to assign/sublet the premises. The landlord’s desire to control the premises will increase to the extent that the rent provided in the lease is below market and/or if the other provisions in the lease are tenant-favorable. To this end, the landlord’s preferred language will prohibit assignment and subletting without landlord’s consent, and provide further that such consent may be withheld in landlord’s sole and absolute discretion. In some instances, a landlord-oriented lease will permit the landlord to terminate the lease or recapture the portion of the premises which is proposed to be subleased, upon tenant’s request to landlord that it approve a proposed assignment sublease. Depending on how it is drafted, this right to terminate the lease (also known as a “recapture right”) can be particularly onerous if it impacts the entire premises in situations where the tenant wishes to sublease only a portion of the premises. In some cases, however, tenants are not strongly opposed to a landlord’s recapture right to the extent it provides a tenant with the possibility of surrendering a lease (if landlord exercises its recapture right) that the tenant could not otherwise terminate.

At a minimum, a tenant will want its right to assign and/or sublet subject to landlord’s reasonable discretion. The more favorable provision for the tenant is one that lists the factors to be considered by a landlord in order for the landlord’s decision to be considered reasonable. The provision that lists those factors, which, if satisfied, obligate the landlord to provide consent, is even more favorable for the tenant. Ideally, the tenant will want the consent provision to list the criteria which, if satisfied, obviate the need for landlord’s consent to the proposed assignment/sublease. These factors typically include: i) creditworthiness of the prospective assignee/sublessee, although this may be less of a factor depending on the significance of the creditworthiness of the original tenant; ii) the proposed use of the premises by the prospective assignee/sublessee; and iii) the character/reputation of the prospective assignee/sublessee.

Additionally, the landlord will want the lease to provide that the landlord is entitled to some portion, if not all, of the amount by which the assignment proceeds/sublease rent exceed the rent payable by the tenant pursuant to its lease. The tenant will typically permit the landlord to retain fifty to seventy-five percent of the excess assignment/sublease proceeds. This is usually a fair compromise from most landlords’ perspectives as well.

6. Condition of the Premises

Most leases provide that the tenant takes the premises "as is," without any representations or warranties from the landlord regarding the condition of (i) the premises, (ii) the building in which the premises are located, or (iii) the land on which the building is located. It is extremely difficult to get a landlord to make any of these representations in the lease. Accordingly, the tenant should be sure to conduct its own due diligence with respect to the premises, including both the building and the property. Due diligence usually requires the tenant to: 1) obtain a copy of the certificate of occupancy for the premises, if available, or, at a minimum, for the building; and 2) order an inspection to be performed by a qualified/knowledgeable party, as well as an employee of the tenant who is knowledgeable of the tenant’s operational needs in areas such as
communications, electrical capacity and computer systems. To the extent the tenant contemplates constructing initial improvements in the premises, the party engaged to construct those improvements should not only physically inspect the premises, and the building, but also review the applicable building department records to determine how much work will need to be done to the premises, and the building, in order for the tenant to obtain the necessary approvals for its improvements.

7. Parking

For tenants that are leasing premises outside of Manhattan, parking issues tend to be significant. (For those tenants that are leasing space in Manhattan, parking is typically not provided, due to the general lack of availability.) Ideally, the tenant will want to ensure that it has parking rights that include a sufficient number of spaces for its employees, clients and visitors. While landlords may accommodate the tenant’s requested number of parking spaces, the tenant should also be sure that its parking spaces are leased, rather than licensed, since, generally, a license is a right that is revocable by the landlord. If parking rights are important to the tenant’s business and no alternative parking arrangements are available in proximity to the leased premises in the event the tenant loses its parking privileges, e.g., as a result of condemnation or casualty, the tenant may want to make the loss of parking rights an event that triggers tenant’s termination rights. (Most leases will provide that the tenant has termination rights if some portion of the premises or the building is destroyed or condemned.) The landlord can avoid having to grant such termination rights to the tenant by providing, if possible, alternative parking arrangements for the tenant within reasonable proximity to the premises.

8. Events of Default

The tenant will want to make sure that the time periods during which tenant is permitted to (i) be in breach without being in default (called a “grace period”) or (ii) cure the default (called a “cure period”) are not too short. Typically, seven days for payment default (from when due) and thirty days (following notice) for all other default events, are fair from both the landlord’s and tenant’s perspective. Landlords will generally not want a payment default period that must be triggered by landlord’s notice. The tenant will want the 30 day non-payment default period to be extended for a reasonable additional time period in situations where the default cannot be cured within the prescribed time period, provided the tenant has commenced the cure within that time period and has continued to pursue the cure throughout that time period. Landlords will not object to such an extension, but may want to impose an outside date (sometimes called a “drop dead” date) by which the tenant’s delays, no matter what the reason, can no longer be excused. The parties will generally settle between 60 and 120 additional days for the drop dead date.

Aside from the time periods that determine when events of default become ripe, landlords and tenants generally agree, with a few exceptions, on which events will constitute events of default. The tenant will want to make sure that vacating the premises, by itself, is not an event of default. The landlord should be agreeable to such a request, as long as the lease does not contemplate that the tenant is using the premises for retail purposes. The landlord may want a cross-default provision pursuant to which a default under the lease being negotiated results in a default in any other leases between the tenant and landlord and vice versa. Most tenants will try to avoid having these provisions in their lease, but may not care if they haven’t entered into and don’t anticipate entering into any other leases with this landlord.

9. Taxes and Operating Expenses

Most leases provide that the tenant will pay its proportionate share of increases over a designated “base year” for the real property taxes and operating expenses attributable to the
property and building where the premises are located. The term “real estate taxes” should be
defined to exclude income taxes, franchise taxes, and personal property taxes due and payable
by the landlord. Most leases will provide for this exclusion, or, if not, most landlords will agree to
revise the lease accordingly. There exists, however, a greater point of contention in what should
comprise and, consequently, what should be excluded from the defined term “operating
expenses”. Most leases will define operating expenses as all of the costs and expenses incurred
by landlord in connection with the operation, maintenance, and repair of the property. The
landlord-oriented form of lease will exclude few, if any, expense items from that general
description. The tenant, therefore, will want to ensure that certain line items are excluded from
the general category of operating expenses. Some costs incurred by the landlord which should
be excluded from the definition of operating expenses are:

1. Casualty restoration costs for which landlord has received reimbursement;
2. Cost of services provided by landlord to other tenants, but which are not provided to the
   tenant under the lease;
3. Legal fees incurred in connection with the negotiation of new leases or enforcing terms of
   an existing lease, as well as in-house legal and accounting fees;
4. Construction supervision and management fees in excess of arms-length amounts;
5. Landlord's overhead and administration expenses; and
6. Advertising, promotional, and marketing costs of the building and/or property.

The landlord may not have the flexibility to provide the tenant with its requested exclusions, and
generally, will only be able to grant those exclusions that are consistent with (i) its existing
accounting for the building operating expenses and (ii) the other leases in the building.

The exclusions from operating expenses can be one of the most time-consuming and hotly
contested areas of lease negotiations, but, if satisfactorily resolved, can result in the greatest
savings to the tenant and, by avoiding potential disputes, to the landlord as well.

10. Landlord’s Services

Most leases will or should address, in some fashion, the services that the landlord is required to
deliver/make available to the tenant's premises. These services typically include heating,
ventilating, and air-conditioning, (known as “HVAC”), elevator (passenger and freight), electricity,
cleaning, running water, and sewerage. The tenant will want the lease to specify the days and
times when these services will be provided at no additional cost to the tenant, as well as the rates
and times for “overtime” services. The tenant will also want the lease to specify the quantities in
which the landlord’s services will be provided to the premises. For example, the tenant will want
the lease to specify at which outdoor temperatures the landlord will make air-conditioning and
heating available to the premises. The landlord will want to avoid specificity here, preferring,
instead, language requiring that it deliver services at levels that are reasonably necessary for
tenant to operate its business. This is not an unreasonable compromise since it avoids potential
disputes over services which are delivered in a manner that permits the tenant to operate its
business, even though those services are not delivered according to the specifications set forth in
the lease.

The tenant will also want to ensure that it has the right to cure landlord’s breach of its obligations
to provide these services and to set-off against rent, the costs incurred by the tenant plus some
amount of interest, which are necessitated by tenant’s cure of landlord’s breach, to the extent that
the landlord has not reimbursed tenant for those costs. Additionally, the tenant will want a termination right if the interruption of any services render the premises untenable for a period in excess of a designated period of time. However, the tenant will probably face very stiff opposition from the landlord to a requested right to cure, set-off, and/or terminate.

11. Tenant’s Right to Terminate

Tenants will almost always want to obtain as many termination rights as possible. The most frequently requested enumerated events which trigger such termination rights are 1) casualty/condemnation, 2) untenantability of the premises as a result of events other than casualty/condemnation, and 3) landlord’s breach of its obligation under the lease. While termination rights as a result of 1) are generally not difficult to obtain for most tenants, generally, only tenants who are leasing significant amounts of space for significant periods of time at market rent or greater will be able to acquire termination rights triggered by events 2) or 3).

Of equal, if not greater significance, for nonprofit tenants is the possibility of a loss or decrease in its funding. Accordingly, the nonprofit tenant will want to have termination rights triggered by such changed circumstances. Landlords should not necessarily oppose such provisions, since the reality of non-inclusion of such termination rights is that the landlord might be left with a defaulting, judgment-proof tenant. Presumably, the landlord has taken into account the economic risks of renting to a nonprofit tenant in determining the business terms of the lease. If this is true, then the landlord should be willing to provide in the lease that the tenant’s termination right be triggered by failure of funding.

12. For the Tax-Exempt Landlord: Income Tax and Real Property Tax Concerns

There are two concerns of particular interest for tax-exempt organizations acting as landlords: rents that may generate unrelated business income tax (UBIT) for the nonprofit landlord; and the possibility that property owned by a tax-exempt organization and leased to another entity may be subject to local real property taxes.

A. Rents Subject to Income Tax – UBIT

A tax-exempt organization acting as a landlord needs to carefully determine whether the rent it receives is considered taxable income subject to unrelated business income tax ("UBIT") – or whether these rents will be considered as exempt, nontaxable income.

1. UBIT Generally: Tax-exempt organizations that engage in income-producing activities unrelated to the organization’s charitable mission may be subject to income tax on that income. Section 512(a) of the Internal Revenue Code (IRC) imposes a tax on the gross income (less directly connected expenses) of an exempt organization for activity that constitutes an “unrelated trade or business.” Three criteria must be satisfied for the activity to constitute an “unrelated trade or business.” The activity must be (1) a trade or business; (2) regularly carried on; and (3) not substantially related to the organization’s exempt purpose.

---

1 This article discusses the UBIT rule generally, and the provisions relating to rental income specifically. For a more detailed discussion of UBIT and the rental income rules, please contact the Pro Bono Partnership or counsel.
2 I.R.C. 513(a); Treas. Reg Section 1.513-1(a).
2. Rental Income: Generally, income from the rental of real property is excluded from the UBIT rules, and is not subject to tax. However, there are several things to consider regarding this exception:

a. If personal property (e.g., furniture and office equipment) is leased with the real property, the exclusion from UBIT only applies if the rents attributable to the personal property are an incidental amount of the total rents received (less than 10% of the total rent). If the personal property rent is between 10% and 50% of the total rent, the exclusion applies, but only to the percentage of rent attributable to the real property; and if the rent attributable to the personal property is more than 50%, all of the rent is taxable.

b. "Insubstantial" services provided by the landlord under the lease (e.g., trash collection, cleaning of public areas) will not negate the UBIT rental exclusion, but if the landlord provides "substantial" services under the lease to the tenant (services provided primarily for the convenience of the tenant, e.g., the supplying of cleaning services), then the landlord will lose the exclusion.

c. The exception to UBIT will not apply if the rents are based in whole or in part on the income or profits derived by any person from the leased property, other than an amount based on a fixed percentage or percentages of receipts from sales. For example, if a lease provides that the nonprofit landlord is to be paid 20% of the tenant's annual net profits from the sales conducted on the leased premises, the rental income will not qualify for exclusion from UBIT computation. However, if the amount of rent is set as a fixed percentage of the tenant's gross receipts (which is different from the profit or loss of the tenant), it will fall under the UBIT exception.

d. A portion of rental income that would otherwise be exempt may be subject to UBIT if the property is "debt financed" – meaning property for which there is an "acquisition indebtedness" at the time the income is produced or within the prior 12 months (essentially, debt incurred to acquire or improve the property, like a mortgage). For example, a nonprofit landlord receiving $10,000 in rent on a building that is one-half debt financed would pay UBIT on one-half of the rent received.

B. Real Property Taxes

Exemption from real property tax is governed by state and local law, and tax-exempt landlords need to carefully review applicable law to see if leasing property (which might ordinarily be exempt from tax) would cause all or a portion of that property to be subject to tax.

1. New York: Exemption from real property taxes is governed by Sections 420-a and 420-b of the NY State Real Property Tax Law (RPTL). The RPTL allows for real property tax exemptions if (1) the property is owned by a religious or charitable organization (the specific types of qualifying organizations are set forth in the RPTL); (2) the property is

---

3 I.R.C. 512(b)(3)(A)(i)
4 I.R.C. 512(b)(3)
5 Treas. Reg. Sections 1.512(b)-1(c)(5)
6 I.R.C. 512(b)(3)(B)(ii)
7 However, the definition of "debt-financed property" does not include property where substantially all (at least 85%) of its use is related to the performance of the tax exempt landlord’s exempt purposes. I.R.C. Section 514.
8 In order to calculate the exact amount of UBIT in a given year, the nonprofit landlord needs to determine the "average adjusted basis" and the "average acquisition indebtedness" of the property. See I.R.C. Section 514.
rented to the type of organization included in RPTL 420-a.2 (which generally includes nonprofits); (3) the rent does not exceed the carrying, maintenance and depreciation charges of the property (or portion thereof)\(^9\), and (4) the property is used exclusively for tax exempt purposes.\(^{10}\) Thus, a NY tax-exempt landlord renting to a for-profit, an individual, or an entity not set forth in RPTL 420-a.2, will not get the benefit of property tax exemption. Or, if there is a nonprofit tenant, but that tenant is doing something on the premises which is not related to its purposes, then the property will not qualify for an exemption.

2. **Connecticut**: Exemption from real property taxes is governed by Connecticut General Statute (CGS) Section 12-81. Section 12-81(58) notes that real property leased to a tax exempt charitable, religious or nonprofit organization, and used exclusively for the purposes of the tax exempt tenant, is exempt from property tax if there is a local ordinance allowing for such an exemption.\(^{11}\) Thus, Connecticut landlords need to see if there is a local ordinance allowing for such an exemption.

3. **New Jersey**: Exemption from real property taxes is governed by New Jersey Statutes Annotated (NJSA) Section 54:4-3.6, which is very specific as to which charitable organizations are exempt from real estate taxes. However, each municipality takes a unique approach to enforcing the statute. Nonprofits in NJ that own real estate are well advised to review their bylaws and articles of incorporation to ensure that the organization's governing documents include one or more of the specific charitable purposes named in the statute. For certain types of NJ charities, the facilities and land must be used exclusively for charitable purposes, such that the act of renting space -- even to another nonprofit -- will disqualify it from property tax exemption.

For any organization renting out all or part of its property, consider having a pass along clause in the lease regarding property taxes, or ensure that the rental amount will cover such taxes.

**Conclusion**

As noted in this article, nonprofit landlords and tenants need to consider a variety of issues before entering into a commercial lease. Careful attention should be given to all of the lease terms, so that the parties can enter into a mutually beneficial tenancy.

---

\(^9\) NY RPTL Section 420-a.
\(^{10}\) NY RPTL Section 402-a.1(a)
\(^{11}\) CGS Section 12-81(58). Also, charitable organizations that own real property and use the property for the organization’s own exempt purposes may claim an exemption from property tax. CGS Section 12-81(7).