

COMMERCIAL LEASE PROVISIONS AND ISSUES

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A. Commercial Case Law and Legislative Update

The tides of real estate law do not turn quickly. There are not a large number of reported cases in New Mexico dealing with real estate concepts in each year. Below are summaries of a few of interest that have been decided in this century.

1. *United Properties Limited Company v. Walgreen Properties Inc.*, 134 N.M. 725, 2003 NMCA 140, 83 P.3d 535 (Ct. Ap. 2003). A lease provided for renewals of six successive periods of five years each. The lease was assigned to a new tenant when three renewal periods remained. Tenant spent over \$1.272 million in capital improvements on the property and subleased portions of the property. Tenant failed to renew the lease until after the required time to do so as prescribed in the lease. Landlord notified tenant and subtenants that they would have to vacate the property. The District Court of Bernalillo County granted summary judgment to the tenant. On appeal, the Court of Appeals held that forgetfulness was not the equivalent of a mistake and found for the landlord.

2. *WXI/Z Southwest Malls Real Estate Liability Company v. Mueller*, 137 N.M. 343; 2005 NMCA 46; 110 P.3d 1080 (Ct. App. 2005). The Ritters leased space in the mall from WXI/Z Southwest Malls Real Estate Liability Company on a ten year lease. Approximately eight years into the lease the Ritters assigned the lease to the Muellers. Southwest Malls, as landlord, consented and approved the assignment on the condition that the Ritters would continue to be liable and guarantee the lease. The Muellers later assigned the lease to Aspen Ventures Accord, Inc., and the landlord again consented as

long as both the Ritters and Muellers continued to be liable. Aspen failed to pay rent starting in August 2000. Southwest Malls filed suit and eventually asked the court to grant summary judgment against Aspen Ventures, the Ritters and the Muellers for amounts due under the lease. The Ritters and Muellers as the guarantors of the lease claimed that they were entitled to prompt notice from the landlord that the rent was not being paid and that the landlord breached the duty of good faith by failing to provide such notice. The District Court denied the landlord's summary judgment, but the Court of Appeals held that the landlord had no duty under the guaranty to provide notice of the default prior to filing suit because the guarantees were absolute and therefore, the landlord was entitled to summary judgment. In analyzing the guaranty issue, the court concluded that the Ritters' guaranty was absolute because the plain language imposed no condition precedent upon their liability to pay rent. If a guaranty is determined to be a "continuing" guaranty, notice would be required, but if the guaranty was "restricted" no notice would be required. The District Court concluded that the guaranty was absolute but could not determine if it was continuing or restricted. The Ritters characterized their guaranty as a continuing guaranty because more than a single payment was contemplated, but the appellate court determined that it was a restricted guaranty because the obligation to pay a reasonably ascertainable rent for a fixed period lets both the depth and duration of the liability be easily known at the outset of the guaranty. While the guaranty language states that it is "continuing," the court concluded that term referred to the obligation continuing through the term of the lease and was not dispositive of the nature of the obligation. The Ritters were free to insist on a notice requirement or any other condition or limitation in their guaranty, but having failed to do so, the court refused to write such a condition in after the fact.

3. *Krieger v. The Wilson Corporation*, 139 N.M. 274; 2006 NMCA 34; 131 P.3d 661 (Ct. App. 2006). This case involves broad indemnification provisions running from the tenant to the landlord and the question of whether such language required the tenant and its insurer to indemnify the landlord from a claim arising from the landlord's negligence. The plaintiff, a patron of the tenant's restaurant, filed a claim against the landlord, owner of the building, for damages arising from a fall in the parking lot of the premises leased to a tenant. The lease required the tenant to keep the premises in a clean and safe condition and also contained language whereby tenant indemnified the landlord, stating, "Lessee further agrees to indemnify and hold Lessor harmless from any and all claims ... arising or in any way resulting from Lessee's activities ... or of ... its licensees..." The District Court granted summary judgment for the tenant, finding that the lease had no language placing liability on the tenant for accidents which occur in the parking lot. Overturning the District Court and remanding for further proceedings, the Court of Appeals stated that it is possible the language of indemnity is broad enough to encompass an accident of a customer of the restaurant and include indemnification for the landlord's own negligence.

4. *United Rentals Northwest, Inc. v. Yearout Mechanical, Inc.* 148 N.M. 426; 2010 NMSC 30; 237 P.3d 728 (2010). The Tenth Circuit Court of Appeals certified the following question to the New Mexico Supreme Court: Is a contract for the rental of a scissor lift to be used in the construction of an aircraft hangar a "contract or agreement relating to construction, alteration, repair or maintenance of any real property," and therefore a "construction contract" as defined in Section 56-7-1(E)? Under Section 56-7-1,

““construction contract” means a public, private, foreign or domestic contract or agreement relating to construction, alteration, repair or maintenance of any real property in New Mexico and includes agreements for architectural services, demolition, design services, development, engineering services, excavation or other improvement to real property, including buildings, shafts, wells and structures, whether on, above or under real property.” The court determined that an agreement for rental of equipment used in construction fit the definition of a contract “relating to construction.”

5. *Henderson v. Vescovo*, 2011 N.M. App. Unpub LEXIS 216 (Ct. App. 2011). In this premises liability case, the district court awarded summary judgment to the defendants, landlord, on the grounds that they owed no duty to plaintiff. The appellate court noted in its proposed summary disposition that the defendants clearly owed a duty of ordinary care, including “acting reasonably to inspect the premises to discover possible dangerous conditions of which he does not know, and taking reasonable precautions to protect the invitee from dangers which are foreseeable from the arrangement or use of the property.” The defendants argued that they lacked actual notice of the facts indicating a need for inspection. However, the court’s analysis states that the duty of ordinary care is only limited by notice from the tenant if the dangerous condition arose after the landlord relinquished control over the premises. The plaintiff took the position that a reasonable inspection prior to turning over the premises would have revealed the dangerous condition. The Court of Appeals overturned the lower court’s summary judgment and remanded the case for further proceedings.

As to legislation, of the several bills were introduced in the 2013 legislative session related to real estate, three of note passed through the house and senate. At this

point, we do not know the fate of all of these bills, except that the Governor has signed the revision to the New Mexico Subdivision Act, which revised the definition of the thirteenth exception to the definition of subdivision. Section 47-6-2 NMSA 1978. The revision appears to be one to make that exception consistent with the other exceptions listed in the act and does not appear to make any substantive changes.

SB 212 revised real estate brokers' licensure to completely remove the concept of salesperson and re-define qualifying broker and associate broker, clarifying their roles. The bill also provides for changes in non-resident licenses, allowing for the waiver of 60 of the 90 hours of instruction for New Mexico licensure upon proof of completion of those hours of instruction in another state. Further, the revisions specifically require a written referral agreement between nonresident brokers and New Mexico associate brokers or qualifying brokers.

SB 146 provides significant revisions to Article 9 of the Uniform Commercial Code. These were instigated by the Uniform Laws Commission. It is beyond the scope of this paper to discuss the revisions in detail, but if a landlord is taking a consensual lien on a tenant's property as a part of the lease transaction, it is important to learn about these amendments. If signed by the Governor, they will go into effect July 1, 2013.

B. Drafting Considerations: Forms, Attorneys' Fees

Virtually every transaction document has its beginnings in one or more other documents. In reviewing prior forms for use in a leasing transaction, it is fundamental that you need to understand the purpose for which the form was originally developed. Is it. Some questions to ask yourself:

- Who do you represent? Landlord or tenant?
- Type of property? Office, retail, industrial?
- Single or multiple tenants?
- Does the lease contain common area maintenance or operate expense provisions and does my deal call for those?
- Are there existing leases for this property that have provisions that would need to harmonize with each other? For example, common area maintenance, hours of operation, any requirements in other leases that bind the landlord to include certain provisions in all leases?
- Is this a form already used in New Mexico or in another jurisdiction?

If you are starting with a client's standard form, it is still worthwhile to inquire about the desirability or applicability of any provisions about which you have questions since every transaction is different. Using a standard pre-printed form can be a place to start, but it is good to have a checklist of items you want to make certain are covered by such a form.

Drafting, and even reviewing and revising a form of lease, can be expensive. It is necessary to understand from your client what is important to them with regard to the landlord-tenant relationship. When reviewing a form provided to me, either by my client or by the opposing party, I like to review it, make notes about deal-point questions I have, then have a discussion with my client about those questions. Even if a letter of intent or term-sheet has been provided, leases are generally much more detailed than the term sheet; therefore, there will likely be additional provisions or details to discuss with the client.

As to the question of attorneys' fees, usually each client pays for its own attorneys' fees related to the drafting and negotiation of the lease. With respect to attorneys' fees provisions in the lease itself, there can be two different types of provisions. Often leases contain a provision that the cost of collecting any past-due rent is borne by the tenant, including attorneys' fees. Additionally, the boiler plate of lease forms often contain an attorneys' fees provision related to the right of a prevailing party to obtain attorneys' fees in the event of a dispute. If both of these provisions are contained in one lease, an ambiguity can arise as to whether the landlord must be a prevailing party on the rent collection issue in order to be entitled to attorneys' fees. While no one would expect a landlord to pursue rent not owed to it, it is possible to imagine a scenario where there are off-set rights or rent has been miscalculated, or there is some other dispute that could call into question which party prevailed. Therefore, it is important to clarify which provision regarding attorneys' fees has priority over the other.

Another common attorneys' fees provision in leases entitles the landlord to reimbursement for any attorneys' fees paid in association with review of an assignment request or completion of a landlord estoppel certificate. As the tenant's lawyer, consider capping such fees at a specific amount per review in order to provide some certainty about cost to your client.

C. Default and Remedy Clauses

Often, tenants focus on the default provisions rather than the remedies provisions under the theory that controlling what is a default is a more immediate problem than what happens after a default. Also, it can seem like a tenant is capitulating to the fact that it may default by negotiating over what happens upon such a default. Nonetheless,

both the landlord's and tenant's lawyers need to make certain the default and remedies provisions work from each of their client's perspective.

One of the main focuses of tenants with regard to default and remedies provisions is notice and an opportunity to cure. However, from a landlord's perspective, the type of default bears on whether notice and cure rights are appropriate.

1. Monetary Defaults.

Landlords usually do not provide for any type of notice requirement for a default involving the payment of rent or other amounts expressly provided for in the lease, such as utilities, percentage rent, and common area maintenance. It is not unusual for a landlord to give a short grace-period in which to make payment. As a practical matter, a landlord may give notice and an opportunity to cure prior to declaring a default based on failure to pay, but generally, leases do not require such notice.

2. Curable and Non-curable Non-monetary Defaults.

Landlords usually provide for notice and a cure period related to curable non-monetary defaults, meaning those that are of a type that can be cured, for example, failure to make a repair. There are other types of non-monetary defaults that are not technically curable, and therefore, a landlord may not provide for a cure period for such a default. An example of a non-curable, non-monetary default would be making an assignment for the benefit of creditors, the insolvency of borrower, or assigning or subletting the property without landlord's consent. Arguably, these types of defaults could be cured, but landlords do not necessarily want to give the right to cure where third-party rights may have vested or have been created. It is worth considering these differences when drafting default provisions and considering cure periods.

3. Landlord's Default and Tenant's Remedies

Many form leases and leases drafted by landlords do not contain landlord's default and remedies provisions related to such default. Tenant's lawyers will want to include these and provide comparable notice and cure provisions as those afforded the Tenant.

4. Unusual Default Provisions.

Tenants should look closely at any unusual events of default, particularly issues like a "go dark" clause where the tenant is in default if it is not open and operating in the space. Whether such provisions are reasonable may depend on the type of use by the tenant and the relative bargaining strength of the parties.

5. Remedies

Theoretically, the relationship between the landlord and tenant created under a lease includes elements of common law leasehold relationships, rooted in the concept of privity of estate, and elements of contract law, rooted in the concept of privity of contract. This theory comes into play when thinking through a landlord's remedies.

Generally, a landlord will want to have its choice of the following three remedies:

(a) Right to re-enter and re-let on Tenant's Default. Under this provision, the landlord can remove the defaulted tenant from the premises, take possession without terminating the lease with the tenant, and relet the premises on the tenant's behalf. The concept of the lease not being terminated is important here as that allows the landlord to continue to

collect rent from the tenant going forward to the extent the landlord is not made whole through the rent received from reletting.

The lease provisions may require mitigation of damages, and a landlord in its own self-interest may want to mitigate its damages, but under New Mexico law, a landlord is not required to mitigate its damages. *Mesilla Valley Mall v. Crown Industries*, 111 N.M. 663; 808 P.2d 633 (1991); *WXI/Z Southwest Malls Real Estate Liability Company v. Mueller*, 137 N.M. 343; 2005 NMCA 46; 110 P.3d 1080 (Ct. App. 2005). The landlord could merely continue to collect rent from the tenant for the remainder of the lease term.

(b) Right to terminate the lease. A landlord will also want the right to terminate the lease and take the premises back. Careful landlord's lawyers always want to make certain whether their client really wants to terminate the lease or whether the client wants to re-enter and re-let on the tenant's behalf. Termination of the lease ends the tenant's obligation to pay any additional rent going forward, and the landlord can only collect past-due rent.

(c) Right to accelerate rent. Separate from the first two concepts, which arise out of the common law concept of privity of estate, modern landlords also often include a contractual right to accelerate future rent to the present and collect now the benefit of the future rent owed. *P.S.G. Ltd. Partnership v. August Income/Growth Fund VII*, 115 N.M. 579; 855 P.2d 1043 (1993). Usually, this acceleration provision contains an agreed upon the discount

rate to be used to reach the present value of the future lease payments.

Also, it may contain the concept of reduction in the damages paid by the market rent to be obtained by the landlord in the future. The tenant should consider whether the discount rate is appropriate and how the market rent provision works when reviewing this part of the remedies provision of the lease.

D. Parties to the Lease, Occupants; Rent and Term

No matter whether you represent the landlord or the tenant, you should confirm that you have the exact and proper names of the parties in the lease. While this sounds so basic as to go without saying, I have reviewed several leases where there have been problems with one of the parties being properly identified. I strongly suggest that you always check entities with the registering agency, such as the Public Regulation Commission, in order to confirm the name is correct, especially if you plan on filing a financing statement on behalf of the landlord because the exact name is required under the Uniform Commercial Code.

Also, it is important to understand the landlord's interest in the leased premises. Usually, the landlord owns the leased premises, but sometimes, the landlord is only a lessee, or perhaps, the landlord is a ground lessee who owns the building. Understanding title allows the drafting to tailor the lease to the facts, as well as to make certain the landlord has the rights it is granting under the lease and necessary third-party consents for leasing have been obtained.

Rent is generally a matter of the commercial terms, but it is important to make certain it is expressed clearly in the lease. For example, make certain to clearly state what

rental amount is owed monthly, rather than stating only the annual amount due with general language about it being divided into equal monthly installments. Reviewing rent escalation provisions for clarity is also very important. At what point must the rental rate be set? Are there actions that must be taken in order for the rate to be determined, such as a determination of the increase in the consumer price index? Does one party need to give notice to the other party of the amount of the escalated rent?

Often, landlords and tenants determine to include a provision about “market rent” for future renewal periods. Without more, there will likely be a disagreement in the future about how to determine market rent. It is better to have the parties agree on a process up front describing how market rent will be determined rather than argue about it later. If the parties do not want to do that, the tenant should, at the least, include language that says that rent will remain the same during the renewal until agreement on market rent is reached. A landlord may want to make sure that once agreement on market rent is reached, the tenant will have to make up the difference between what was paid and what is owed by market rent.

In retail leases, rent provisions sometimes include percentage rent, an additional rental payment based on revenues generated at the location. Percentage rent provisions require clarity in what figures the percentage is based on, what information must be provided by the tenant to the landlord to show the calculation of percentage rent, and what audit rights the landlord has to determine whether the information provided is correct.

The term of the lease is likewise a matter of commercial negotiation. Any renewal terms need to be spelled out with clear language about how the renewal terms are exercised, including by what date notice must be given.

The converse of renewal rights are special rights related to early termination. In the retail context, these can include loss of an anchor tenant, material changes in tenant mix, and failure to meet certain sales figures. Other actions that could give rise to termination rights are changes in areas critical to the tenant's operations, such as loading docks or essential ingress and egress. In agreeing to any early termination rights, a landlord will want to include a provision allowing for recoupment of any special tenant improvements paid for by landlord. A landlord will want as much notice as possible in order to be able to relet the premises, and a landlord will not want to leave the termination right open-ended. Upon the trigger allowing termination there should be a limited period of time in which the tenant must give notice of termination. In certain termination contexts, if the reason for termination is within the landlord's control, the landlord may include a notice and cure right prior to the termination right actually accruing. Sometimes termination rights provisions will also require a tenant to pay a liquidated amount for the privilege of being able to terminate.

E. Rights that Cannot be Waived or Modified

Most terms of the relationship between a commercial landlord and a commercial tenant are subject to the terms of the agreement between the parties. However, in crafting that contractual relationship, there are underlying requirements that cannot be changed between the parties to the contract.

At the heart of the commercial landlord-tenant relationship is the notion of quiet enjoyment. A landlord and tenant, even in a commercial context, cannot effectively agree to waive the notion of quiet enjoyment. The right to possess the premises is implied in every landlord-tenant relationship. *Barfield v. Damon*, 56 N.M. 515, 245 P.2d 1032 (1952)

However, the parties likely can define that notion and limit what a commercial tenant can consider to be infringing on its quiet enjoyment. For example, recently there was an interim lease where the seller of property was leasing back a portion of the space while the buyer of the property made other space ready for occupancy. The parties expressly agreed that the tenant's quiet enjoyment was modified by the understanding that construction would be occurring around the tenant's space, including some of the common areas to which tenant would have access. The tenant still had possession of the premises, but the modification to the express provision of quiet enjoyment expressly prevented the tenant from claiming that the construction activities interfered with quiet enjoyment or constructively evicted the tenant.

The property and the activities on the property must comply with applicable laws, such as building codes and land use requirements. The parties to the lease can contractually shift the responsibilities for compliance with these laws, but the landlord, as the owner of the property, will remain responsible to the government for the property. Environmental laws provide another legal overlay for landlords and tenants under which responsibility can be shifted between the parties, but regulatory agencies and third parties seeking enforcement of those laws are not bound by the lease terms.

Other considerations that are similar to code compliance issues are covenants, conditions and restrictions that have been placed on the property. Both the landlord and tenant will need to be aware of those requirements and make certain the terms of the lease take into account any use restrictions, building and approval requirements provided for in those CC&R's.

Insurer's requirements for insurance coverage to be effective also need to be dealt with in the lease. If the landlord is carrying insurance on the building, the tenant's activities or alterations to the premises could cause issues with that insurance. Therefore, the parties need to be sure that the tenant is contractually obligated to comply with the insurer's requirements. Likewise, any requirements by the landlord's or tenant's lenders need to be considered when drafting the lease.

Contractors and material suppliers working on the property have statutory rights that can affect both landlords and tenants. Usually, leases provide that tenant's work on the property cannot result in a mechanic's lien. Under the mechanic's lien statute, there is a mechanism whereby a landlord can post a notice of non-responsibility so that any lien posted will not attach to the landlord's interest in the property. A lease can provide for a tenant to give sufficient notice so that the landlord has time to post the notice of non-responsibility prior to work starting on the property.

F. Disclosure Obligations

As a general matter of property law, a landlord should disclose to a tenant information about the property which the landlord knows and which the tenant could not reasonably have discovered upon examination. *Hogsett v. Hanna*, 41 N.M. 22, 63 P.2d 540 (1936); *Calkins v. Cox Estates*, 110 N.M. 59, 792 P.2d 36 (1990). On the tenant's side, if the landlord has maintenance duties, the tenant must give notice to the landlord regarding needed repairs or the landlord will not be responsible for injuries arising from the condition to be repaired. *Gourdi v. Berkelo*, 122 N.M. 675; 1996 NMSC 76; 930 P.2d 812 (1996).

G. Tenant Improvements

A landlord may agree to pay for some portion of tenant improvements. It is generally a matter of commercial bargaining power. Therefore, the amount of tenant improvement reimbursement will be highly negotiated for each individual lease. Other considerations of a landlord in agreeing to pay for tenant improvements are whether the improvements are likely to carry over to a future tenant. Improvements which can only be used by a limited universe of the specific tenant may be less likely to be paid for by a landlord than more general improvements usable by many future tenants.

Who pays for the improvements is a different question than who is charged with getting the work done. If the tenant or its contractor is actually completing the work, the landlord will have specific insurance requirements, such as builder's risk and general liability insurance during the term of completion of the construction. The landlord will require notice of commencement of construction sufficient for the landlord to post a notice of non-responsibility for the work being completed on behalf of the tenant.

Whether a landlord is paying for tenant improvements or not, the landlord will want to approve the improvements to insure that they are not going to negatively affect the property. Likewise, the landlord will want to at least approve the contractor who will be performing the work. Sometimes, a landlord may agree to pay initially for the tenant improvements, but recoup the cost of such improvements over the life of the lease through payments of additional rent. Even if the landlord does not include a separate category of additional rent for tenant improvements, the landlord may still want to recoup

any unamortized tenant improvement expense in the event of an early termination, either as allowed by the terms of the lease or through a tenant breach.

If a landlord is agreeing to actually complete certain portions of the work for the tenant, the landlord will want to be very specific about what work it is obligated to do and to what standard the work will be performed. The landlord will not want a tenant to have complete discretion to accept or reject work performed by or on behalf of the landlord.

If the tenant or its contractor is completing the tenant improvements, there will be negotiations about when the tenant can occupy the space for the purpose of completing the improvements and whether rent will be owed during the build-out of the tenant improvements. If the landlord is willing to give some free rent during the period of tenant improvement installations, the landlord will want to have a date certain after which rent accrues. Usually the landlord will set that date a certain period after possession is turned over to the tenant or the date the tenant opens for business, whichever occurs first. A tenant will want to be certain not to begin paying rent during the period the improvements are being made to the premises. At times, the landlord and tenant agree to a compromise whereby the tenant pays common area maintenance expenses but no base rent during the period of build out of the tenant improvements. A tenant who is not able to get a landlord to pay for all of the tenant improvements may still be able to get the landlord to finance the cost of the tenant improvements with the tenant repaying the cost of those improvements over the life of the lease.

The landlord will also want to be clear about whether the tenant can remove any or all of the tenant improvements upon expiration or termination of the lease. A landlord will want to consider the likelihood of destruction to the premises by removal and the value of the tenant improvements to a future tenant. Usually tenants are fine with leaving tenant improvements in the premises upon termination or expiration. In fact, a tenant will not want to have to incur additional costs to remove tenant improvements from the premises. This attitude won't extend to any trade fixtures that can be used at the next premises. The tenant will want the right to remove them and will want to be sure that the restoration requirements are reasonable and include usual wear and tear

H. Operating Expenses, Taxes, and Insurance

1. Operating Expenses, including Taxes

Provisions related to operating expenses can arise in single tenant leases or multiple tenant leases. These provisions relate to recoupment of the landlord's expenses associated with owning and operating the property as a whole. When there are multiple tenants, the provisions related to this recoupment are sometimes referred to as common area maintenance. The common area refers to areas that are not within the exclusive possession of a particular tenant. Common areas generally include parking lots, sidewalks, foyers, hallways, and common bathrooms. In multi-tenant buildings, operating expenses address those common areas as well as all other expenses of the landlord necessary for operation of the property.

In order to negotiate the provisions related to operating expenses, it is important to understand the usual industry terms associated with payment of expenses: gross lease, net lease, and triple net lease. This paper includes definitions

commonly used by owners, brokers, tenants and lawyers, but simply because a lease is referred to as "gross" or "net," it doesn't have a particular statutory or other legal meaning attached to it. The terms of the lease will govern who pays for what operating expenses.

Typically, a gross lease or a full services lease is a lease where the landlord pays all of the costs of operating the property, including taxes, maintenance, insurance and utilities in exchange for a single monthly rental payment by the tenant. A net lease means that in addition to monthly rent, the tenant pays one or all of the following: taxes, insurance and maintenance (and some people include utilities in the category of net lease). Leases are sometimes referred to as single net, double net and triple net, each adding another component of taxes, insurance and maintenance (and utilities). Finally, some landlords like to refer to their leases as absolute net leases, apparently meaning that all costs of owning and operating the property are paid by the tenant. Some commentators try to make a distinction between triple net leases and absolute net leases based on whether there are legal defenses to failure to pay the operating costs. However, the terms of the lease itself will govern the parties' remedies associated with payment or failure to pay operating costs.

Somewhere between a gross lease and a net lease is a modified gross lease. In such an arrangement, the parties begin with a base year in which the costs for operating expenses are set, then the tenant is responsible in future years for any increases in those operating expenses over the base year.

Once a determination is made as to what operating expenses are being passed through, the landlord and tenant must agree on the tenant's share of those

expenses. In a single tenant lease, presumably the tenant will pay 100% of the operating expenses it has agreed to pay. In multiple tenant properties, it is customary to base the tenant's proportionate share on the square footage of the leasable area included in tenant's leased premises.

The Landlord wants to recoup all costs associated with owning and operating the property. The landlord can do that through a gross lease arrangement, but the landlord will be at risk for changes in the operating expenses beyond what was contemplated when the rent was set.

In a net lease arrangement, a landlord will want a broad definition of operating expenses. These expenses will be generally defined as all costs of owning, managing, operating, maintaining and repairing the property. A landlord will want to include as many specific items of operating expenses as it can in order to avoid a dispute later about whether a particular expense came within the broader definition.

Items of operating expense that are commonly agreed to by landlords and tenants are the direct costs associated with maintenance and management personnel: wages of direct employees or fees charged by third-party managers; taxes; insurance; utilities not separately metered for leased premises; and the costs of maintenance and repairs.

Items that landlords do not usually include in operating expenses are mortgage payments, attorneys' fees, and leasing commissions. Some landlords may include depreciation expense in operating expenses. Advertising and promotional expenses may be included, but in retail contexts there are often separate advertising cooperatives that require fees separate from the landlord's operating expense.

Administrative fees for management may be included by a landlord and are usually expressed as a percentage of the total operating expense or as a percentage of the management expense line item.

Capital expenditures require special consideration. While a landlord in a net lease wants to recoup the full cost of capital expenditures, it is not necessarily fair for a tenant, who happens to be in the building at the time of a major replacement, to be required to foot that bill. In order to address such a concern, a landlord may include an amortization of such capital expenses over the life of the equipment installed.

Another expense area of contention is costs associated with compliance with laws, which could be viewed as a subset of capital expenses. If a landlord's building is no longer up to code, should the tenants be responsible at all for such expense? If the code violation is a result of one tenant's activities in the building, should other tenants share in the cost of such expense?

Ideally, the proportionate shares of all tenants will add up to 100% and the landlord will be fully reimbursed for operating expenses. However, two things can happen with that ideal: (1) a property may not be fully leased and (2) there could be a change in the actual availability of space for lease--for instance there is a condemnation or destruction of some portion of the building. The first risk can be mitigated by setting the tenant's proportionate share against actual leased space, and the second risk can be mitigated by making clear that the proportionate share figures could change with revisions to the building. As you'll see below, neither of these concepts is popular with tenants.

Another common provision related to operating expenses is the gross-up provision. A gross up provision allows a landlord to allocate operating expenses on the theoretical basis of a certain occupancy percentage: usually 95% or 100%. This allows the landlord to charge each actual tenant a larger amount for all or certain categories of operating expenses when occupancy falls below the assumed percentage. Gross up provisions really apply to variable costs of operating property, such as utilities, janitorial service, and trash removal. Fixed cost items, such as taxes, shouldn't be increased because there is no change in the charge with occupancy.

The benefit to the landlord by including gross up provisions is that it shifts some burden for variable costs to the tenant. As an extreme example consider a two tenant building where one tenant vacates. The remaining tenant is actually using 100% of the electricity, but is only paying for 50% of it. The gross up provision would make the landlord whole in such an instance.

Gross up provisions are generally not favorable to a tenant, requiring it to pay more for certain variable operating expenses than it would pay without the gross up provision. A tenant will want the lease to be clear that the gross up only applies to costs that actually vary with occupancy and may want an ability to audit the grossed up numbers to make sure the landlord has not overstated them. There is one context in which grossing up costs assists a tenant. In a modified gross lease where there is a base year for operating expenses, a tenant will want the operating expenses grossed up for purposes of the base year calculations so that the tenant's share of the base year costs is set at a realistic number, unrelated to the actual occupancy of the property.

The tenant wants to be sure that it is not paying more than its fair share of the operating expenses. Therefore, one of the first things a tenant is concerned with is the calculation of its proportionate share of operating expenses. The tenant will want to make certain the proportionate share is related to the total gross leasable area of the premises rather than the area under lease, which could expose a tenant to increased costs in the event of decrease in occupancy. Also, a tenant will want to make sure the proportionate share stated in the lease is a cap. For example, if there were a catastrophic loss destroying a portion of a shopping center and the landlord chose not to rebuild, the tenant would not want its proportionate share to increase.

Next, the tenant in a net lease will want to make sure that the actual expenses it is paying for address ownership and operation of the property and are fairly capped. A tenant may attempt to place a cap on the annual increases in operating expenses. While this sort of cap may be fair with regard to expenses that can be controlled by the landlord, the landlord is unlikely to agree to a cap on expenses that are not within its control: insurance, taxes, and other third party costs. With or without such a cap, a tenant will also want to include a right to audit the expense records of the landlord and have some mechanism for repayment if they are determined to be inaccurate.

A tenant should be aware of expenses that are not actual out-of-pocket costs for the landlord. Administrative fees that are unrelated to actual salaries or third-party fees should be strictly scrutinized. Interest on mortgage loans, while an out-of-pocket cost of landlord, would seem removed from the operation of the property and not properly passed through to the tenant. Depreciation expense is not an actual cost

to a third party, but rather affects tax liability associated with ownership of the property. Attorneys' fees and brokers' commissions associated with leasing other portions of the property should be considered specifically. Advertising and promotional fees may be an inappropriate pass-through if not promoting tenant's business. A tenant may want a specific section of the lease that calls out items that will not be included in operating expenses, even if arguably covered by the broad definition drafted by the landlord.

2. Insurance and Indemnities

The insurance provisions and related indemnities that trigger the insurance coverage can contain language that is highly technical and may be terms of art in the insurance industry. It is wise, whether you represent a landlord or tenant, to have these provisions reviewed separately by your client's insurance broker for his or her input. Among other things, the provisions could (a) differ from typical allocations of risk between landlords and tenants, (b) expose your client to uninsured risks, (c) put your client in breach because the lease requires insurance coverages not carried by your client, and (d) subject your client to increased insurance premiums by reason of the provisions in the lease.

A landlord may be looking at the lease as a guaranteed net income stream and will wish to pick up almost no liabilities except for those ultimately paid for by its tenants, either directly or through operating expense reimbursement. Such a landlord will want to insure the entire project against liability and property damage. Usually such coverage includes a commercial general liability policy and fire and casualty insurance.

The landlord will wish to pass on the costs of those insurance coverage to the tenant through operating expense charges or otherwise.

The landlord will want the tenant to obligate itself to a broad range of insurance to protect the landlord from activities of the landlord. Such coverages might include personal property insurance, property insurance covering fixtures and personal property installed by the tenant, automobile insurance, worker's compensation insurance, commercial general liability insurance and any other liability coverage that might be unique to the tenant's business. The landlord will want to draft in the lease minimum coverage amounts, possibly maximum deductibles, and financial strength and size ratings for the insurer. A reference in a lease to an insurer having a "Best's rating of no less than A-VII" is not unusual; in Best's ratings system, the "A" refers to financial strength on a scale that runs from A++ (Superior) to E (Under Regulatory Supervision), and the "VII" is a financial size category based on the adjusted policyholders' surplus of the insurer that runs from "I" to "XV." A good description of Best's ratings is contained at ambest.com/ratings/guide/asp.

The landlord will want a certificate of tenant's insurance that names the landlord as an additional insured, and will want provisions for notice to Landlord in advance of any expiration or termination of the tenant's insurance, along with a right to obtain substitute insurance and bill the Tenant for the expense. The landlord may seek to name the tenant's insurance as "primary," so that if there is a loss covered by both the landlord's and tenant's insurance policies, the tenant's insurer has to pay. The landlord's attorney will often have the landlord's risk management department or insurance broker

review the insurance provision. The landlord also may want copies of the actual policies, in addition to the certificate of insurance.

Subrogation, in the context of insurance, is the right of an insurance company to collect from the responsible party after it pays a claim. A waiver of subrogation provision is one in which insurer gives up the right to take action against a third party for a loss suffered by an insured. The concept of a "waiver of subrogation clause" applies typically to property insurance policies. In commercial contexts, a mutual waiver has become typical to avoid the problem of subsequent litigation affecting one or both parties arising from insured risks. The parties generally want to have comfort that if a claim is covered by insurance it is not a potential source of liability to the parties. Interestingly, insurance companies, at least in commercial contracts, don't typically object despite the fact that they are giving up a valuable legal right because, in the context of huge insurance companies fighting one another over thousands of claims, the subrogation claims tend to even out and the use of mutual waivers of those rights avoids the substantial attorneys' fees and other costs generated by those subrogation claims. So although some landlords may have language that only the tenant's insurers waive subrogation, typically a landlord will agree to a mutual waiver.

The landlord will want broad indemnities from the tenant (being the main provisions in the Lease for triggering insurance coverage) with respect to activities at the premises, including environmental matters and other actions or inaction of the tenant. The landlord will not want carve-outs from tenant's indemnification obligations except those solely arising from landlord's gross negligence, and will want provisions that limit landlord's liability to its gross negligence and only to its equity in the specific project of

which the premises are a part. The landlord will not want any obligation to the tenant for problems caused by third parties and other tenants and users in the project.

It is very important to be aware of the potential issues affecting the lease as a result of § 56-7-1 NMSA 1978, which in effect requires the inclusion of language from the statute to avoid the contract becoming unenforceable if the lease includes an indemnification provision that could be construed to indemnify a party against its own negligence. This is often the case with leases that have the tenant indemnify the landlord against all but the landlord's gross negligence- by its nature such an indemnity violates § 56-7-1 without including the necessary language. Section 56-7-1 applies to any "contract or agreement relating to construction, alteration, repair or maintenance" § 56-7-1(E). Recent cases have extended the type of contract covered. *See United Rentals Northwest v. Yearout Mechanical, Inc.*, 148 N.M. 426; 2010 NMSC 30; 237 P.3d 728 (2010) (applying the statute to the rental of a scissor lift). The case does not directly answer the question whether the provisions in a typical lease containing rules for altering, repairing and maintaining the premises are sufficient to trigger § 56-7-1 even in the absence of tenant build-out requirements. The effect of omission of the language has been ambiguous in New Mexico. In *Sierra v. Garcia*, 106 N.M. 573 (1987), the New Mexico Supreme Court ruled an entire contract void; the New Mexico Court of Appeals has more recently held that the portions of a contract that indemnified an indemnitee against the indemnitor's negligence are enforceable, despite contractual language that violated § 56-7-1. *Holguin v. Fulco Oil Services LLC*, No. 29,149 (NMCA July 19, 2010). Inclusion of the statutory language will avoid the potential for litigation and a possible adverse outcome.

The tenant will look to the Landlord to provide adequate insurance to cover the landlord's interest in the project, which should be subject to reasonable requirements based on amount of coverage, deductibles/retentions, financial strength of the insurer, and the like. The tenant would like any landlord property insurance coverage to include language such as "on a full replacement cost basis and insuring against Special Causes of Loss, including vandalism and malicious mischief." A tenant, if it is a major tenant, may seek to become an additional insured on the landlord's insurance, and may want to receive proof of that insurance.

I. Assignment and Subletting

A landlord will want no limitations on landlord's right to assign its interest under the lease to maximize the landlord's flexibility and marketability of the property. It will also want to ensure that no future purchaser of the property is liable for actions of the current landlord preceding the closing of the sale to maximize the value of the property. With respect to landlord's rights to assign the Lease, the Tenant may have concerns about a successor landlord having the financial wherewithal to comply with the landlord's obligations under the lease, and it may have concerns regarding possible gaps in liability between the original landlord and the successor. Relying on the original landlord to be liable for defaults prior to closing of a sale that are not then known to the tenant and are not assumed by the successor landlord can leave the tenant exposed, especially where the original landlord is a single-asset entity and may hold no assets once the sale is completed and any cash proceeds are distributed.

Conversely, the landlord will want controls around when and how a tenant can assign or sublet the property. A landlord desires to ensure continued compliance with

lease and proper care of the premises, and the landlord has chosen the current tenant. Bringing in a new occupant of the premises with no past history with the landlord creates potential for loss of control over use and occupancy. Next, a landlord wants to ensure that any permitted assignee or subtenant has financial strength at least equal to original tenant's to comply with lease obligations. A landlord does not want to compete with the tenant in leasing space in the project; therefore, sublease rates may be subject to approval by the landlord or sharing by the landlord in any windfall the tenant realizes by subleasing or assignment. No matter what, a landlord wants the existing tenant to stay obligated on the lease to ensure that the tenant has a continuing financial stake in lease compliance. A tenant may argue that in the face of keeping the tenant obligated under the lease, a landlord should not have any substantial approval rights for assignment or subletting.

A landlord may want parameters around a stock acquisition of the tenant, as well, and that type of "assignment" may be addressed in the assignment and subleasing language. Failure to specifically address change in control or assignment by operation of law, such as a merger, may result in those types of arrangements not triggering landlord approval rights. A tenant, however, will want broad rights to assign to affiliates in the event of some corporate restructuring event within the tenant's organization, and would prefer silence in any assignment clause with respect to transfer of any interest in the tenant (via a stock sale or other transfer of ownership) to preserve maximum flexibility in the event of a sale of the company. If the Tenant is a public company (or a company that may become public), special care needs to be given to a provision that would require consent for conveyances of ownership interests (or shares) of the tenant to ensure public float of shares does not trigger a default or consent requirements.

A tenant wants flexibility to rid itself of premises not needed for its operations. At the least, a tenant will want to make certain if any landlord consent is required, it cannot be unreasonably withheld or delayed, which could either be written in general terms or specified with agreed upon criteria for an acceptable assignee or subtenant.

J. Use Restrictions

The tenant will want to carefully consider the use provisions in the lease, making certain they are sufficiently broad for tenant's use the use of any likely assignee or subtenant. If the use clause is too narrowly tailored, it may inhibit a tenant from successfully marketing the premises to another potential user. For a tenant that sees itself possibly selling itself as a strategy, the ability of an acquirer, which might have different strategic plans for the business than current management, to deal with the premises flexibly could affect the valuation of the tenant in the acquisition.

K. Renewals and Extensions

A landlord's position on renewal provisions is a tension between the certainty of having the space leased and the uncertainty of fluctuation in market rent during the term. This tension affects a landlord's willingness to enter into a long-term lease and its willingness to allow renewals that are optional in the tenant's discretion. A landlord is generally willing to agree to a renewal option so long as the landlord can accept the risk of the agreed upon renewal rent being lower than what the landlord could get from another tenant. Some landlords want annual increases in rent while others will only expect an increase at the renewal. If the initial term is relatively short, five years or less, it is

unlikely that the landlord will agree to additional tenant improvement allowances at the time of renewal. A landlord will want sufficient notice of non-renewal in order to find another tenant.

While escalation provisions can be drafted in a number of different ways, they are usually either an agreed upon percentage increase period over period, an adjustment based on the change in the consumer price index, or a reset to market rates. With a percentage increase, a landlord is assured an increase in rent (rather than a potential decrease as could occur with the other two escalation approaches).

An escalation provision tied to the consumer price index (CPI) creates an objective process for determining the increase in rent and is believed by some to better match the actual change in the cost of owning and operating the property. A landlord using this method will want to make sure that the specific index chosen best reflects the increase in costs in the applicable market. The landlord also may want to state that the existing rent is a floor; even if the CPI change for the applicable period were negative, then the rent would not decrease. Other drafting considerations around this type of an escalator are to make sure when the index is published so that the change can be determined before rent is reset and to make sure there is an alternate index or process if the specific CPI index referenced is no longer used.

A market rate reset can be the most fair to both parties, but it has its inherent uncertainties. A landlord will want to create an agreed upon process for appraisal of the market rate, looking at truly comparable properties in the same geographic region. If there are any specific amenities that should be considered in the appraisal, those should be

included in the lease provisions regarding market rate. Sufficient lead time will need to be provided to complete the appraisal process. A landlord also needs to consider the cost of the process by which market rent is set and who pays for that process. Like with the CPI escalator, the landlord may want to make clear that the reset rate will not be lower than the current rental rate.

To a tenant, a renewal option provides a low cost way of tying up property for longer than the initial term. A tenant will most likely not want the renewal to be automatic but to require the tenant to affirmatively elect the option to renew. If the initial term is fairly long, ten years or more, the tenant may expect some additional tenant improvement allowance for refurbishment at the time of renewal.

Depending on the tenant's business, some tenants may wish to obtain a lower initial rent and exchange that for higher future rent. For example, a start-up business projecting significant revenue increases in years 5 and 6 may trade lower early rent for higher rent in the future for cash-flow purposes. The tenant considerations for CPI adjustments are similar to the landlord's: sufficient time to compute the new rent and audit rights on computation of the new rent, if the landlord is computing it. With both CPI escalations and market rate resets, a tenant may wish to cap annual or period rent increases in order to avoid complete uncertainty about future rent. This is the tenant's equivalent to the landlord's requirement for an absolute floor on the rental rate.

L. Arbitration Clauses

Attorneys and their clients differ on their feelings about dispute resolution clauses. Some parties prefer that that any dispute first be subject to a requirement that the dispute

be escalated to the CEO's (or equivalent) of each party within a relatively short period of time. This is to ensure that knowledgeable, experienced businesspeople can attempt to settle a dispute early without the expense of attorneys. Mediation clauses are sometimes included in commercial agreements, but a typical Landlord will not want mediation in a lease because they feel that the Tenant is the party most likely to default and they want to avoid the procedural delay arising out of a mediation process. Occasionally you will see arbitration provisions in leases, but not all that frequently. Often a waiver of jury trial is included.

M. Guarantees

Lease guarantees are fairly common, especially with single-space or single-asset tenants. Depending on the tenant's entity structure these guarantees can be a parent guaranty or a guaranty from the individual owner or owners of the tenant. Lease guarantees are generally unlimited, except that a landlord should agree to allow a substitute guarantor in the event of a lease assignment by the tenant.

From the landlord's perspective, it is important to include the guarantor's consent up front to lease amendments without the guarantor's consent, waiver of any notice provision, and the ability to pursue the guarantor without having to exhaust any remedies against the tenant. Even with blanket consent to lease amendments, if there are amendments to the lease, it may be worthwhile to obtain consent from the guarantor to avoid an argument later about whether the guarantor is bound to the amended terms.

From the tenant's or guarantor's perspective, it is important to provide notice of a tenant's default along with the right to cure the default by the guarantor. Substitution

language upon assignment should include an objective standard to allow substitution, such as the same or better financial condition as the guarantor.

A drafting issue to make certain to clarify in lease guarantees is that the guarantee applies to all renewal periods. If a new, voluntary renewal is made, likely a new lease guarantee will need to be entered into. Additionally, consider specifically addressing the guarantee of any holdover rent and rental period.