

Commercial Leasing Bulletin:

Tenant Negotiating 101 - A Simple Guide to the Commercial Lease

June 9, 2022

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You've found the perfect location to kick start your business. Now, if you could just get all the paperwork done so you can start renovating and decorating the space. Before you race to scribble on the signature line, ask yourself: what exactly am I signing? It's easy to get caught up in the excitement of finally finding your business' new home, but if you're not careful, you may be surprised at what you have agreed to in your lease.

For a lease to be binding, it must contain the following essential elements:

- identification of the parties,
- a description of the premises,
- the amount of rent payable,
- the commencement date, and
- the duration of the term.

In addition to these fundamental elements, each agreement may have other material terms depending on the nature of the deal. Whether for retail, office, or industrial space, a lease agreement is important to your business. Oversight of crucial terms can be detrimental to the parties involved.

So what should a tenant be aware of before signing a commercial lease agreement? We will outline some of the most commonly found provisions in a standard lease and why you, as a tenant, should pay attention to them when negotiating.

Financial Obligations

Let's talk money. Financial obligations are undoubtedly key to any agreement. If the numbers don't work, an entire deal can fall apart.

Gross Lease or Net Lease

Generally speaking, a commercial lease can either be a gross lease or a net lease.

Gross lease: the tenant pays a single amount to the landlord, which covers base rent and all incidental expenses.



Net or triple net lease: the tenant pays base rent and its share of all operating costs, taxes, and other incidental expenses.

Base Rent and Additional Rent

In a net lease, rent is divided into base rent (or minimum rent) and additional rent.

Base rent: a set amount per square foot of leasable area in the premises or a fixed annual amount divided into equal monthly payments.

Additional rent: “other costs,” including property taxes, insurance, utilities, or operating costs (also known as common area costs), and more. This category of costs can add up very quickly.

As a tenant, you need to understand what fees are captured under “additional rent” for better budgeting. If possible, negotiate a “capped” increase on certain costs (such as operating costs) to help create some stability in annual increases for those expenses.

It is also beneficial to include estimates of various additional rent charges. Note that these are only estimates. The landlord is not held to them if circumstances change, but the groundwork will have been laid for what the tenant can reasonably be expected to pay ahead of the lease being signed.

Percentage Rent and Breakpoints

In addition to base rent and additional rent, some commercial tenants will also pay percentage rent. Usually found in mall leases and multi-tenant locations, percentage rent is calculated using either a natural or artificial breakpoint.

Natural breakpoint: the annual base rent divided by the stated percentage rate. For example, if the annual base rent is \$75,000 and the percentage rate is 5%, then the natural breakpoint is \$1.5 million ($\$75,000 / 5\%$), and the tenant would be required to pay 5% of any gross sales over \$1.5 million.

Artificial breakpoint: a dollar amount of sales agreed to between the parties, which means the tenant would pay a specified percentage over that dollar amount. For example, if the parties agree to \$800,000 but the total gross sales are in fact \$900,000, the tenant would pay 5% of \$100,000 as percentage rent.

It is helpful for tenants who pay percentage rent to understand how varying percentage rates will impact their financial situation.

Operating Costs/Common Area Costs

Operating costs or common area costs are generally shared by all tenants in a shopping centre and include fees for snow removal, janitorial services, landscaping, property management, etc.

Remember when negotiating an operating costs provision that a tenant should only be charged for its proportionate share of the costs of the complex as a whole. Tenants should carefully review the definition of the proportionate share. Landlords routinely exclude from the denominator the areas occupied by tenants who do not contribute costs on the same basis as the majority of tenants. As a result, the proportionate share is higher for each of the tenants in the majority. Tenants should also avoid language that allows the landlord to reallocate operating costs at its sole and absolute discretion. The tenant may end up subsidizing other tenants who have negotiated a ‘sweet deal’. In addition, tenants should ensure that structural repairs and replacements are to be paid by the landlord and not through operating costs. Capital expenditures may be included in operating costs; however, the cost should be amortized over the useful life of the item.

Permitted Use, Expiry Date Clauses, and Other Key Items

Aside from finances, another critical component of a lease is the tenant’s permitted use. A “permitted use” clause is intended to outline the type of business that a tenant is entitled to operate from the premises. Depending on the complexity and/or uniqueness of the tenant’s business, this clause should be carefully drafted to ensure the tenant is not restricted in what it is able or not able to do from the premises. Most tenants prefer a broad use clause, which allows the permitted use to expand and evolve. A landlord may require a narrower clause to avoid tenants competing against (or, even worse, cannibalizing) each other. Give special attention to this clause to ensure that the interests of both parties are balanced.

Take this concept one step further and negotiate an exclusivity right, which is typically more common in a retail lease. Being permitted to conduct your business as you wish is crucial, but having the exclusive right to that use in the development is even better. It involves a landlord covenant (restrictive covenant) to not lease space to a competitor after the lease is signed. An exclusive use right may be negotiated depending on the size of the development and the size of the premises.

Premise Conditions

Provisions that deal with the premises during the term are important, but clauses that dictate the condition of the premises on the expiry date cannot be undervalued. To understand the implications of such a clause, we must consider the difference between trade fixtures and leasehold improvements.

Trade fixtures: personal property placed in, or affixed to, the premises used in connection with the tenant’s business operations (e.g., displays and signs).

Leasehold improvements: improvements made that are “attached” to the property and become the property of the landlord at the end of the term (e.g., flooring or built-in shelving).

Aside from the work required to install both trade fixtures and leasehold improvements, there can be considerable work (and cost) involved in removing them. If a tenant is not careful, they may inadvertently agree to be responsible for removing anything and everything that the landlord requires - including bringing the premises back to its “base-building condition.” Although a tenant will likely want to de-identify the space, having to revert to how the premises existed on the possession date is an onerous and costly task. Accordingly, tenants should be wary of any restoration obligations found in a lease and understand what they are responsible for (even before the term commences) upon the expiration or earlier termination of the term.

Other Items for Review

Other key items to look out for include:

- relocation rights,
- redevelopment,
- demolition,
- landlord termination rights,
- security deposits payable,
- personal indemnity requirements,
- any change to terms that come into effect during an extension option.

You may not be able to completely negotiate your way out of these provisions, but you should know if they are included in your agreement and when they can be enforced (for example, a relocation right that is exercisable by the landlord at any point during the term, or only after the initial term). It is also a good idea to bargain for a lengthy notice period. If the landlord wishes to terminate the lease due to its intention to demolish the building, you should receive at least six months’ notice before your lease is terminated.

Key Takeaways

In many cases as a tenant, you will be signing the landlord’s standard form of lease agreement. Even so, you still have the opportunity to negotiate terms that are more favourable to you. Take the time to consider each term and what you can, or cannot, live with. Every tenant will have different needs based on the nature of their business. It is vital to determine what is important to you and how you can best arrive at a balanced lease that satisfies the interests of all parties. Whether a sophisticated tenant entity or not, it is always a good idea to consult with a leasing lawyer before entering into negotiations or finalizing a lease agreement with another party.

We will continue to provide updates on commercial leasing topics of interest. If you have any questions or would like to obtain legal advice on any leasing issues or litigation, please contact any lawyer in our Commercial Leasing Group.



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