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BASIC TYPES OF LEASES

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J. Cary Barton is a graduate of Baylor University (B.A. 1962) and Harvard Law School (LL.B. 1965) and was admitted to the State Bar of Texas in 1965.

He worked for the Federal Power Commission and the U.S. Tax Court in Washington, D.C., following his graduation from law school and served in the United States Air Force during the U.S.S. Pueblo crisis in Korea. He has been engaged in the private practice of law in Texas since 1969, consisting of six (6) years in Corpus Christi, 13 years in Austin and the period since 1988 in San Antonio.

He is currently the senior member of Barton Benson Jones PLLC, a nine-lawyer firm in San Antonio, Texas, that was founded in 2018. He is Board Certified in Commercial Real Estate Law by the Texas Board of Legal Specialization and his law practice consists primarily of representing real estate developers and investors in commercial real estate transactions.

Mr. Barton is a member of the American College of Real Estate Lawyers. He was a member of the Real Estate Forms Committee of the State Bar of Texas from 1986-2017. He served two four-year terms as a member of the Council of the Real Estate, Probate and Trust Law Section of the State Bar of Texas. He is a Sustaining Life Member of the Texas Bar Foundation, which named him as one of its five 2016 Outstanding 50 Year Texas Lawyers.

Texas Lawyer named Mr. Barton as one of five finalists for the "Go To" real estate attorney award in Texas in 2007 and 2012. He was selected as a Texas Super Lawyer 2003-2015 by Texas Monthly and Law & Politics Magazine, including recognition as one of the Top 50 Lawyers in Central and South Texas in 2006 and 2007, one of the Top 50 Lawyers in Central and West Texas in 2009 and 2010 and one of the Top 100 Texas Super Lawyers in 2007. He was listed as one of San Antonio's Best Attorneys in Scene in SA Monthly in 2004-2015. He has been included in The Best Lawyers in America (Real Estate) (Woodward White) for the years 1987-1988 and 1997-2015 and was selected as The Best Lawyers in America Lawyer of the Year in real estate in San Antonio for 2014. He was named as one of two outstanding real estate lawyers in San Antonio by the San Antonio Business Journal in 2012.

Mr. Barton received the fourth annual lifetime achievement award for contributions by a distinguished Texas real estate lawyer from the Real Estate, Probate and Trust Law Section of the State Bar of Texas in 2003.

He received the Best Speaker Award for the 2004 Advanced Real Estate Law Course of the State Bar of Texas for his presentation entitled "Feasibility Issues/Can I Do the Deal?"

He was one of four Texas lawyers granted a Standing Ovation award in 2009 for his contributions to continuing legal education programs sponsored by the State Bar of Texas.

He received the Ralph A. Mock Award from Texas Lawyers Concerned for Lawyers in 2009 in recognition of his assistance to impaired Texas lawyers.

He received the TexasBarCLE Weatherbie Workhorse Award at the 2010 Advanced Real Estate Law Course of the State Bar of Texas.

He is the editor of Texas Practice Guide: Business Entities, Volumes 1-4 (Thomson-Reuters, 2015).

He is a member of the Founders Council of the Embrey Real Estate Finance and Development Department of the School of Business of the University of Texas at San Antonio and of the Real Estate Council of San Antonio. He recently served on the Relocation Committees for the San Antonio Children's Museum "Doseum" and for Dress for Success San Antonio.

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1. INTRODUCTION.

The author has endeavored in the following paper to identify some of the more important provisions that will normally be found in a typical commercial lease agreement. In most instances, these provisions are discussed in the context of the respective negotiating objectives of the parties. In some cases, these issues are being addressed in other presentations during this conference and the discussion here is of a more summary nature. Generally, an effort has been made to focus on the issues which will commonly be encountered in most leasing situations, although some issues which have been discussed are primarily of concern with respect to more specialized types of property or leasing arrangements.

2. PARTIES TO THE TRANSACTION.

Each lease transaction involves, of necessity, a landlord (or lessor) and a tenant (or lessee). Some leasing arrangements may also involve one or more guarantors of the tenant's performance under the lease. In some situations, subtenants (or sublessees) may also become involved in the agreements between the parties.

Each party to the lease should assure that the lease accurately identifies the other party in order to be certain that the correct party has agreed to be bound to perform the obligations arising under the lease and that those obligations will be enforceable against the appropriate person if a default occurs. If entities are involved in the transaction, efforts will also need to be made to confirm that the entities are properly organized and in good standing in the jurisdictions where such entities are organized and are qualified to do business in the jurisdiction where the leased premises are located. In addition, parties will want to obtain evidence that the appropriate directors, managers, partners or other necessary governing persons with respect to all entities participating in the transaction have authorized the lease.

Accurate information should be included for giving notices under the lease. Such information should include street addresses and telephone numbers for personal or courier deliveries to parties that use post office addresses for delivery by mail. The notice information should also include facsimile numbers and email addresses if notices by such means are permitted. The responsible parties to whom notices are to be addressed should be named. Provisions for changes in any of the information regarding notices should provide that such changes will not be effective until some agreed minimum amount of time has passed after notice of the changes is given in order that the other parties may correct their records to reflect such changes. If the tenant does not want to be bound by notices delivered to the leased premises, care should be taken to be sure that any provision in the landlord's standard lease form permitting notices to be given to the tenant in such manner is modified accordingly.

If the landlord is not satisfied as to the financial ability of the tenant to perform its obligations under the lease, the tenant may be required to provide a guarantor of such obligations or provide some other form of enhancement of the tenant's creditworthiness such as a letter of credit, extraordinary security deposit or other means. If a guarantor is required, the guaranty agreement will usually impose a guaranty of payment on the guarantor and not just a guaranty of performance and will otherwise be very similar to a guaranty of a commercial loan in terms of the guarantor's liability for the tenant's defaults. If a guarantor is required and the guarantor is an entity, the landlord will want to obtain the same sort of organizational and authority documentation regarding the guarantor as was described previously with respect to the tenant.

In some cases, particularly in connection with professional service firms such as lawyers or accountants, the principals may not be willing to enter into joint and several guaranties of all of the obligations of the tenant for the entire term of the lease. In some situations, the parties may agree that the principals will have several liability for those obligations equivalent to their ownership percentage in the tenant entity (or some agreed multiple of that percentage to provide a modest amount of overlapping coverage). In other situations, with both professional firms and other guarantors, the parties may agree that the principals or guarantors will be liable only for the unamortized portion of the tenant finish costs and leasing commissions that were incurred by the landlord at the inception of the lease. In some cases, a combination of these two approaches may be used. A related issue that often arises in connection with professional service firms is whether a principal in the firm who has some liability for the lease continues to be responsible for such obligation if the principal subsequently dies, retires or otherwise leaves the firm, either voluntarily or involuntarily. These requirements can sometimes affect the decision by a professional firm to lease space in a particular property. In other cases, although probably rare, these requirements can result in a decision by the principals to dissolve the firm rather than incur a liability with which they do not feel comfortable in connection with a lease of office space for the firm.

3. DESCRIPTION AND MODIFICATION OF LEASED PREMISES.

Providing a legally sufficient description of the leased premises is vital to the enforceability of the lease. Descriptions by street address are generally not legally sufficient. Consequently, the simplest situation would involve leased premises consisting of an entire tract of land (and any improvements thereon) that can be

described by means of a metes and bounds description or plat reference in the same manner as would be appropriate for a conveyance of real property.

Usually, however, the leased premises will consist of only a portion of the improvements constructed on a tract that can otherwise be legally described, but no legal description will be available for the portion of the improvements that is being leased.[1] In those situations, additional information must be provided in the form of suite or space designations, sketches, dimensions or some other means that would enable a court to determine with sufficient specificity exactly which portions of the improvements on the described tract of land are subject to the lease in question.

The dimensions of the leased premises are essential factors in determining the tenant's responsibilities for rental payments and the tenant's relative responsibilities for common area charges, taxes, utilities and other pass-through expenses. In many cases, the parties specify the dimensions of the leased premises in the lease agreement. In other cases, particularly in pre-construction leasing situations, the lease agreement provides for the dimensions of the leased premises to be determined by an agreed method of measurement by an independent party after the construction has been completed. In the latter case, the lease agreement will ordinarily provide for the parties to execute a memorandum or amendment of the lease specifying the measured dimensions of the leased premises once that determination has been made.

In connection with multi-tenant buildings, the size of the leased premises is often stated in terms of an agreed number of square feet of "net rentable area" of the leased premises. The "net rentable area" is usually the sum of the "net usable area" of the leased premises, which is the area that a tenant actually occupies and uses, plus an "add-on factor" for the particular property, which represents an allocation to individual leased premises of the common areas and other portions of the property not designed for occupancy by tenants. In comparing lease rates and other costs between prospective properties, a tenant should be careful to insure that apparent differences in economic terms are genuine and not attributable to differences between the properties in the methods of calculating the dimensions of the prospective leased premises.

A prudent tenant will usually request that the landlord provide information regarding the landlord's title to the prospective leased premises. The tenant will want to have this information in order to assure that the landlord does, in fact, own the premises that the landlord is proposing to lease to the tenant. The tenant will also want to assure that there are no restrictive covenants or other title exceptions that would or could adversely affect the use of the premises by the tenant. Of particular interest in this latter respect will be information regarding liens against the premises securing debts of the landlord to third parties. The tenant will want to obtain subordination, non-disturbance and attornment agreements with all such lienholders. The tenant will also want to determine if there are any recorded use restrictions affecting the leased property that would prevent or limit the tenant's proposed used of the premises if they are not amended or waived. Although not obtained as a matter of course in Texas, tenants who are making substantial investments in their leased premises may want to obtain title insurance insuring their leasehold estates. The premium for such title insurance will ordinarily be determined on the basis of the aggregate base rentals that the tenant will be required to pay during the initial term of the lease. There does not appear to be significant precedent in Texas regarding the question of which party will be responsible for paying the premiums for obtaining such leasehold title insurance, so this issue may be the topic of substantial negotiation in situations where obtaining title insurance appears to be appropriate.

In many cases, the parties will negotiate terms and conditions under which the leased premises may be expanded, contracted or relocated. Each of those possible eventualities involves a number of individual considerations.

If the tenant is to have a right to expand the leased premises, the parties will need to agree on whether that right is an option which can be exercised at any time by the tenant or is a right of first refusal which can be exercised only in the context of an offer to lease the described expansion area which is received by the landlord from another tenant or prospective tenant. If the tenant has an option to lease the expansion area, the parties will need to specify whether the rental rate for the expansion area will be the same as the rate then being charged for the primary area or will be determined in some other manner. The parties will also want to agree upon the length of the option if it is shorter than the term of the primary lease and may want to agree on some minimum increments of the expansion space with respect to which the option can be exercised. Usually the term of the tenant's lease of the expansion space will be coincident with the then remaining term of the tenant's lease of the primary space, but the parties may agree on some other arrangement in individual cases. The landlord may want to provide that the option must be exercised or lost if and to the extent that an offer to lease all or part of the expansion area is received by the landlord from another prospective tenant. Typically, if the tenant has a right of first refusal to lease expansion space, the portion

[1] By comparison, note that a lease of a condominium unit can be legally described by reference to the recorded condominium declaration, which should describe both the affected tract of land and the individual unit.

of the expansion space as to which such right is applicable in a particular instance and the rental rate to be paid by the tenant for such portion of the expansion space will be determined by reference to the terms being offered by the other prospective tenant. In some cases, the failure of the tenant to exercise such right of first refusal with respect to an offer which involves only a portion of the expansion space will not affect the tenant's right of first refusal with respect to the remaining portions of the expansion space. In other cases, though, the failure of the tenant to exercise such right of first refusal as to any portion of the expansion space will operate to terminate the tenant's right of first refusal as to all other portions of the expansion space. A similar issue involves the extent, if any, to which a tenant's right of first refusal may be subsequently reinstated in connection with particular portions of the expansion space if the tenant declines to exercise such right initially in a particular instance but that portion of the expansion space becomes vacant prior to the expiration of the term of the primary lease by reason of default by the other tenant or expiration of the term of the other lease. In all cases, the exercise by a tenant of an expansion option or right of first refusal should be conditioned on the continued effectiveness of the primary lease and the absence of an existing or potential default on the part of the tenant. The landlord will normally want the tenant to be required to exercise partial options to expand with respect to portions of the expansion space that are located adjacent to space already leased. The tenant will usually want the landlord to lease portions of the expansion space that are subject to the tenant's right of first refusal that are located furthest from the space already leased.

As might be expected, the issue of a tenant's right to contract the size of the leased premises is encountered less frequently than an expansion right. Some tenants, however, especially professional service firms, may insist on having the right to reduce the size of the leased premises if the size of the firm is reduced for any reason. Landlords may be willing to agree to grant such a right to particularly desirable tenant firms, although that right may be coupled with an assurance that the landlord will be entitled to recover in all events the unamortized portions of the landlord's investment in tenant finish costs and leasing commissions.

Some smaller tenants may be required to agree to grant the landlord a right to relocate the tenant if the landlord needs to do so in order to accommodate another tenant or prospective tenant which needs or wants the space subject to the original lease in question. A tenant that is required to grant such a relocation right to a landlord will want to make some efforts to preserve the benefit of the tenant's original bargain by requiring the landlord to provide the tenant with replacement space which is substantially as desirable as the replaced space (either in generic terms or by describing the specific areas to which the tenant can or cannot be relocated). The tenant will want the landlord to agree not to relocate the tenant to a materially smaller space, and to agree to reduce the tenant's base rent and pass-through obligations to reflect any difference between the replaced space and the smaller replacement space. Conversely, the tenant will want the landlord to agree that the tenant will not be liable for any additional base rent or pass-through obligations if the replacement space is larger than the replaced space. The tenant will want the landlord to agree to bear all costs of relocating the tenant's business to the replacement premises, including tenant finish costs equivalent to those in the vacated space; direct moving costs; rewiring and installation costs for signage, computers, telephones and other systems; costs incurred in reprinting stationery; and costs incurred in changing telephone and other address listings (including changes in address for registered offices of tenant or client entities). The tenant may also ask that the landlord provide the tenant with some sort of agreed or actual allowance for business interruption losses during and immediately following the relocation.

4. TERM OF THE LEASE.

The minimum period of time during which the lease is expected to be in effect is usually described as the initial term or the primary term of the lease. When a lease pertains to leased premises which are currently ready for occupancy or for which the tenant is solely responsible for any necessary renovations or alterations, the initial term of the lease may be stated in terms of a specific period of time beginning on a specified commencement date and expiring on a specified termination date. In situations where the landlord is required to build or renovate the leased premises, the commencement date of the initial term of the lease will generally be stated in terms of a relatively short specified number of days after the landlord has completed its work on the leased premises and the expiration date of the initial term will be stated in terms of a specified number of months or years after the commencement date. If the lease involves the construction of a free-standing, single-tenant retail building, the landlord will often be required to construct only the shell of the building and the tenant will be obligated to complete the construction of the interior of the building in accordance with the tenant's specifications. In this last case, the commencement date of the initial term of the lease will usually be stated in terms of a specified number of days after the landlord has delivered the completed shell of the building to the tenant which is sufficient to permit the tenant to complete its interior improvements and the expiration date of the initial term will be stated in terms of a specified number of months or years after the commencement date.

A distinction should be made between the "effective date" of the lease agreement and the "commencement

date" of the primary term of the lease. The lease should become an agreement that is binding on the parties on the "effective date" when it has been fully-executed. The "commencement date" should be used only as the starting point of the initial term of the lease and not as the starting point of the effectiveness of the lease.

In situations where the landlord is building or renovating the leased premises for the tenant's use, it is usually important for the tenant to know with some degree of certainty when the leased premises are going to be available for the tenant's use. Often, therefore, the tenant will want the landlord to agree to pay liquidated damages and/or reimburse the tenant for actual damages incurred by the tenant if the landlord does not deliver the completed leased premises to the tenant within the agreed period of time. Such damages could include, for example, extraordinary hold-over rentals on the tenant's current leased space during the period of delayed delivery of the new premises. Moreover, the tenant will want to have a fail-safe provision in the lease under which the tenant will have the right to terminate the lease if the landlord does not deliver the leased premises to the tenant within a specified number of days or months after the date originally specified for delivery. It is sometimes not clear whether such a termination right can be exercised by the tenant in addition to or in lieu of making a claim for liquidated or actual damages for late delivery and the persons drafting a lease containing such provisions should endeavor to make the intent of the parties in this regard as clear as possible.

Anchor retail tenants often have year-end and other black-out periods during which they do not want their leases to commence or expire. A landlord will need to take such black-out periods into account in scheduling the negotiations of leases with such tenants and the construction work required to prepare the leased premises for their occupancy.

Tenants are often granted one or more options to renew a lease for one or more specified periods of time. Such periods of time are commonly referred to as renewal periods or extension periods. The lease will need to specify the manner in which the tenant is required to exercise its option to renew the lease for each renewal period. Such procedures generally require the tenant to give written notice to the landlord that the renewal option is being exercised, with such notice to be given not more than a specified number of months or days prior to the expiration of the current initial or renewal term and not less than a specified number of months or days prior to the expiration of the current initial or renewal term. Most leases specify that the tenant may not exercise a renewal option if there is an existing or potential default by the tenant either at the time the option is exercised or at the time the renewal term would otherwise commence.

The issue pertaining to renewal options which is usually most contentious involves the extent to which the rental rate for the renewal term is specified in advance at the time the basic lease is originally executed or is left to be determined by some specified procedure at the time the renewal option is exercised. Although some leases may include specified lease rates for one or more renewal terms, very few leases go beyond the early renewal terms in specifying in advance what the rental rates will be during the renewal terms. More commonly, leases provide that the rental rates which are applicable during the renewal terms will be determined on the basis of the fair market rental value for comparable leased space at the time the renewal option is exercised. Landlords typically want to retain the right to determine what the fair market rental value of comparable space is at that time, although sometimes they will agree to act reasonably and in good faith in making such determinations. A tenant will usually prefer to have a right to refer the matter for decision by some independent arbitrator if the parties themselves are unable to determine the rental rate for the renewal term by agreement. Some renewal option provisions specify that the rental rate for the renewal term will be determined by adjusting the rental rate that is applicable during the initial term of the lease to reflect increases in the Consumer Price Index. If the landlord is not obligated to pay a leasing commission on the renewal of the lease, the tenant will usually argue that a percentage amount equal to typical leasing commissions should be backed-out of the comparable rental rates in determining the rental rate for the leased premises in question during the renewal term. The tenant will want to preserve the right to rescind the exercise of the option to renew the lease if the tenant believes that the rental rate determined for the renewal term is excessive. The landlord might insist on limiting such rescission right to a relative short period of time after the renewal rate has been determined and on eliminating such rescission right if the renewal rate is not more than the rental rate during the preceding initial term or renewal term or other specified amount. A landlord will often require that the rental rate for each renewal period must be not less than the rental rate for the immediately preceding initial term or renewal term of the lease, although a tenant may respond that rental rates are affected by the conditions of the market and the property at the time the renewal option is being exercised and that such factors may have changed considerably since the rental rate was established for the preceding initial term or renewal term.

Occasionally, one will encounter a situation where the tenant is insisting on having a right of early termination with respect to a particular lease. Such issue might arise most typically in connection with a professional service firm, where a contraction or dissolution of the firm would adversely affect both its need for the leased premises and its ability to pay for the premises, or in connection with non-anchor retail establishments in power centers, strip malls or enclosed

malls, where failures to lease-up the other portions of the properties or subsequent vacancies would have an adverse impact on traffic flow for the establishment in question. A tenant that is in a regulated industry may argue that it should be permitted to terminate a lease if regulations are enacted that render it difficult or impossible to operate the location profitably. A landlord may be willing to grant such an early termination right in certain circumstances, conditioned on the payment of a specified amount by the tenant in order to exercise that right. The early termination payment will ordinarily include, at a minimum, the unamortized portion of the landlord's tenant finish costs and leasing commissions.

5. RENTAL PAYMENTS.

The tenant's obligations to pay rentals under a lease are generally described in terms of base rent and additional rent. In retail leases, the additional factor of percentage rents may also be included.

The base rent to be paid by the tenant is a specified amount that is due and payable at specified times without regard to the costs and expenses incurred by the landlord in maintaining and operating the property. The base rent is typically payable in equal monthly installments, although the parties may agree in the lease agreement that the base rent will be adjusted at agreed intervals during the primary term (or a renewal term) on the basis of either an agreed amount or to reflect increases in the cost of living based on some form of the Consumer Price Index or other specified index.

Additional rent is ordinarily a generic term that encompasses all other payments (except percentage rent) that the tenant is obligated to pay to or for the landlord under the lease. Additional rent, therefore, involves factors such as taxes, insurance premiums, common area maintenance costs and costs incurred by the landlord in operating and maintaining the property in which the leased premises are located. Since the base rent typically includes an increment reflecting all of these costs as they were applicable at the time the lease commenced, a lease will often provide that the tenant is not obligated for these additional rental amounts until they exceed the incremental amounts that were included in the original base rent. That provision is described variously as an expense-stop or a base year calculation. If the property is not fully-leased during the base period used in calculating the expense-stop, the tenant will want the costs attributable to the base period to be grossed-up to reflect the full occupancy of the building (e.g. 95%) in order to avoid having to pick-up cost increases in the future which are really attributable to a higher occupancy percentage instead of true cost increases which are properly allocable to the tenant's leased premises.

Several issues should be taken into account by a tenant in negotiating a provision for the payment of additional rent. First, the tenant will want to be sure that only usual and customary operating costs are taken into account in calculating the aggregate amount of costs that will be allocated to the tenants in the property for purposes of determining the applicable amount of additional rent. For example, amounts such as the landlord's payments of principal and interest on its mortgage on the property should not be taken into account in calculating additional rent.

Generally, capital costs for improvements to the property should not be included in the additional rent calculation, but a landlord will often argue that capital costs which result in a reduction in other expenses (e.g., a more efficient HVAC system which reduces costs for electricity) should be recovered by amortizing such capital costs over the estimated useful life of the improvements and including the appropriate amount of such amortization in additional rent for the respective periods of time.

Leasing commissions, tenant improvement costs, attorneys' fees and other costs of leasing other portions of the property and enforcing such leases should not be included in calculating additional rent, but the parties often agree that routine property management costs (including compensation and benefits for management personnel) may be included in calculating additional rent.

Most commercial leases currently being negotiated permit the landlord to estimate the extent to which some amount will be charged for additional rent for the current year and to collect one-twelfth of that amount each month, with a reconciliation provision being applicable at the end of the year when the actual amounts for the year are known.

Occasionally, a particularly strong tenant may be able to negotiate either an absolute or an annual cap on increases in additional rent, but those situations are not encountered often.

Additional rent provisions often permit the tenant to audit the records of the landlord with respect to the calculation of the amounts owed, with the cost of the audit to be paid by the tenant unless a discrepancy in excess of some agreed percentage or amount is discovered, in which event the cost of the audit would be payable by the landlord.

Tenants will want taxes allocated in proportion to all of the leaseable space in the subject property, and not just among the occupied portions of the property. Tenants will also want to assure that the taxes that are being charged to the tenants do not include taxes assessed on adjacent property being held for future development by the landlord. Under the Texas Tax Code, a tenant which is obligated to reimburse a landlord for property taxes is entitled to protest tax appraisals if the landlord does not protest the appraisals.[2] A landlord may want to include

[2] Section 41.413, Texas Tax Code.

provisions in its lease agreements stating (i) that the landlord does not have to disclose to the tenants information about the rents being charged to other tenants and other confidential information regarding the financial operations of the property in support of any such tax protests by the tenant and (ii) that the tenant is liable to the landlord in the event that a protest filed by the tenant results in an increase in the taxes on the property in which the leased premises are located. In view of the statutory right granted to a tenant to file such tax protests, it is not clear whether or not such lease provisions would be enforceable.

Percentage rent terms are often applicable with respect to retail leases. These provisions require the tenant to pay additional amounts to the landlord if the tenant's sales at the leased premises increase to a point where (i) the product of multiplying the agreed percentage by the tenant's gross sales at the leased premises exceeds (ii) the base rent otherwise payable under the lease (this factor is referred to as the "break-point" in calculating the amount owed by the tenant under the lease). Percentage rent provisions set forth in detail the extent to which amounts received by the tenant at the leased premises are or are not to be included as gross sales for purposes of making the percentage rent calculations. The tenant, for example, will want to provide that sales taxes, transfers of merchandise between stores, discounts to employees, interest on credit sales, returns, exchanges, sales not in the ordinary course of business and similar items should not be included in gross sales. The landlord will ordinarily agree with exclusions of that nature. On the other hand, the tenant may also want to exclude from gross sales the discounts charged by credit card issuers on credit card sales, but the landlord may view those discounts as just another cost of doing business. A landlord will want payments of percentage rents for a particular year to begin during the year once the break-point has been achieved, while the tenant will prefer to have the use of the money until the end of the year when the gross sales for the whole year can be determined. The tenant should ordinarily resist basing interim percentage rent payments during the course of the year on annualized average monthly sales to date. Even if such a provision is combined with reconciliation procedure at the end of the year or a catch-up procedure during the latter portion of the year, such interim payments can still result in the landlord's having received percentage rents to which it was not ultimately entitled. At a minimum, any such excess percentage rent payments should be applied to offset the tenant's liability for base rent in subsequent periods, although the tenant's preference would be for the excess amounts to be refunded immediately. Percentage rent provisions will ordinarily permit the landlord to audit the tenant's sales records, with the cost of the audit to be paid by the landlord unless a discrepancy in excess of some agreed percentage or amount is discovered, in which event the cost of the audit would be payable by the tenant. The tenant will often want to impose a confidentiality obligation on the landlord with respect to the tenant's sales records. The landlord will want to include a provision in the lease under which the percentage rent and break-point can be adjusted if a different use is subsequently made of the leased premises and the percentage rent usually and customarily applied with respect to such different use is materially different from that applicable to the use originally permitted under the lease.

6. CONSTRUCTION OR RENOVATION OF THE LEASED PREMISES.

A typical lease will address issues regarding the respective responsibilities of the landlord and the tenant for the construction or renovation of the leased premises. The parties will often negotiate and attach as exhibits to the lease so-called "work letters" which describe the "landlord's work" and "tenant's work" to be accomplished in connection with such construction or renovation in more or less specificity and detail. Carefully drafted lease agreements will identify with great precision the respective obligations of the parties for such work, including detailed quality and quantity specifications of all of the components of such work (e.g., the number and type of electrical outlets to be provided for each specified increment of area within the leased premises).

As noted previously, leases that involve a new single-tenant property may provide that the landlord is responsible for completing the shell of the building and some basic interior improvements, but the tenant is primarily responsible for completing the interior of the building. This type of arrangement will most commonly be encountered in connection with a lease to a national retail tenant that has a standard configuration for the interiors of its stores that it wants to replicate throughout its system, but this division of responsibilities can be chosen by the parties in virtually any leasing situation. Some or all of the costs borne by the tenant in completing the interior of the leased premises may be offset by a "tenant finish allowance" provided by the landlord, which will often be paid when the tenant provides evidence to the landlord that the leased premises have been completed in accordance with the approved plans and specifications and applicable law and that there are no liens regarding such costs which are filed or pending against the leased premises. In some instances, the landlord may agree to advance the tenant finish allowance to the tenant in increments during the course of construction of the leasehold improvements upon the presentation of satisfactory documentation concerning the costs incurred, quantity and quality of work completed to date and the absence of any lien claims against the leased premises.

In a multi-tenant office lease, the landlord will usually want to control the renovation of the tenant's

interior improvements either by performing such improvements itself or by contracting with a third-party contractor selected by the landlord to accomplish such work. The improvements in the leased premises will ordinarily be performed in accordance with plans and specifications that have been approved by both the landlord and the tenant. Typically, the landlord will agree to bear the costs of such improvements up to the amount of a stated tenant finish allowance, with any additional costs being borne by the tenant. The tenant's share of such costs will often be payable in cash, either in advance or at some other stage of the construction process. Sometimes, however, the landlord will agree to pay all or part of such additional costs initially and to recover such additional costs with interest by means of amortizing such costs over the initial term of the lease and increasing the base rentals by the amortized portions of such costs and interest which are allocated to each rental period.

It is always important for the parties to be very clear in specifying what improvements are and are not to be defrayed by means of a tenant finish allowance. The tenant will want as much of the interior costs as possible to be included in the landlord's basic responsibility for the shell or structure of the leased premises. The landlord will have the opposite motivation. Issues that can arise in this area include fire sprinkler systems, interior ceiling system and lighting structures, window blinds and basic floor coverings. Sometimes, work letters will provide that the tenant finish allowance includes carpet and other interior improvements that are of "building standard" quality, with the tenant being required to absorb the cost of upgrading the quality of such components of the improvements. It is important in such situations for the tenant to identify what the building standard quality is so it can quantify the extent, if any, that upgrading will be required to meet its needs or preferences.

7. ALTERATION OF THE LEASED PREMISES.

Standard leases typically provide that the tenant is not permitted to alter the leased premises without the landlord's consent, and may or may not qualify the extent to which the landlord is entitled to withhold such consent. Tenants will often argue that the landlord's consent should not be required to make alterations to the leased premises, as long as such alterations comply with local fire codes and other building regulations and the tenant pays all of the costs of completing such alterations on a lien-free basis. The most apparent motivation for a landlord to insist on having the right to approve such alterations is a desire to control the extent to which the alterations affect the ability of the landlord to utilize the original interior improvements for use by a successor tenant without significant additional cost.

A similar issue can arise from a tenant's perspective, especially in connection with a retail lease. A shopping center tenant will often be concerned, for example, with the extent to which the landlord can use portions of what is currently being used as parking area for the construction of additional buildings which may interfere with the visibility of or access to the tenant's premises or which may reduce the number of available parking spaces in the shopping center. Although encountered less often, an office-building tenant may be concerned with the extent to which the landlord can lease portions of the building for use on a more intensive basis that increases significantly the demands being made on elevators, parking facilities and other building services.

Many leases require that the tenant restore the leased premises to their original condition upon the termination of the lease. Tenants will sometimes request that the landlord qualify that obligation to relieve the tenant of the obligation to remove alterations that were made to the leased premises during the term of the lease with the consent of the landlord.

8. USE RESTRICTIONS.

The lease agreement will usually specify the use that may be made of the leased premises by the tenant, with such use being defined with more or less specificity depending on the situation.

A tenant will ordinarily want the permitted uses of the leased premises to be as broad as possible, primarily for purposes of widening the universe of potential assignees and sublessees. The landlord will want the permitted uses to be as narrow as possible, primarily for the opposite reason of maintaining tighter control over prospective assignees and sublessees. The landlord may also need to be mindful of maintaining a tenant mix which is perceived to be beneficial and of restrictive provisions which may have been included in leases previously negotiated and which might be violated if the permitted uses in a subsequent lease were sufficiently broad to permit a violating use.

Significant tenants in retail centers will sometimes be able to negotiate restrictive covenants barring the landlord from leasing space in the centers to other tenants offering the same or substantially the same services or products. Landlords will want to exclude existing tenants from the scope of any such restrictions and to permit future tenants to offer modest amounts of such restricted services or products as part of a broader array of services or products (e.g., permitting not more than a specified percentage of floor area of such future tenant's space to be devoted to such restricted services or products). Landlords will also want to limit their responsibility to prohibiting tenants from engaging in the specified uses in their lease agreements without having any responsibility for enforcing the restrictions. The restriction should terminate if the tenant that is the beneficiary of the restriction ceases to offer the specified services or products, although the tenant will want to limit such

terminations to situations where it has ceased offering the specified uses or products for a significant period of time, such as six months or a year.

Some use restrictions are not related as much to the type of business being conducted by the tenant whose lease is being negotiated as they are to the impact that certain uses can have on the common areas available to all of the tenants. For example, a retail tenant may insist that restaurants, bars, movie theaters and other entertainment facilities not be located within a specified distance of the subject tenant's leased premises because of the adverse effect that the pedestrian and vehicular traffic and parking requirements attendant to such entertainment venues can have on the ability of the retail tenant's customers to access the leased premises in question.

9. OCCUPANCY AND CO-TENANCY ISSUES.

Some retail tenants want to assure that the shopping centers in which their leased premises are to be located will achieve and maintain a certain minimum level of occupancy in order to generate traffic sufficient to make their operations at such locations successful. Other retail tenants believe that their operations have the best opportunity for success when they are located in shopping centers in which certain other retailers also have established locations. Remedies suggested by tenants for failures to satisfy such occupancy or co-tenancy conditions range from reduction or abatement of rentals to termination of the lease at the option of the tenant. The landlord may agree to reduce or abate base rentals but want the tenant to continue to pay additional rentals and percentage rentals.

If a co-tenancy condition is involved, a prudent landlord will want to try to expand the list of potential co-tenants whose occupancy will satisfy the condition to include other co-tenants whose line of business is substantially the same as that of the acceptable co-tenants identified by the tenant with whom the landlord is negotiating.

The landlord will be presented with somewhat of a quandary about the length of the period of time during which the landlord can satisfy the relevant condition and during which the associated rental abatement will remain in effect. On the one hand, the landlord will want to have as much time as possible to satisfy the pertinent condition without forcing the tenant to exercise an option to terminate the lease in order to avoid being obligated to resume paying rent in the stated amount. On the other hand, the landlord will not want the tenant to have the right to continue to occupy the leased premises for an indefinite period of time while paying little or no rental and deriving commensurate additional profits that may actually be undiminished by the unsatisfied condition. A possible solution of this quandary is to allow the landlord to reinstate the stated rent if the relevant condition has not been satisfied within a specified period of time and to give the tenant a window of time after such reinstatement in which the tenant can terminate the lease without reimbursement for the tenant's remaining costs in the premises if the pertinent condition is not satisfied prior to the expiration of the window. That type of arrangement would seem to provide adequate protection for the tenant's legitimate interests in a manner that does not expose the landlord to a potentially inequitable exploitation of the situation on the part of the tenant.

10. ASSIGNMENT AND SUBLETTING.

A landlord will ordinarily require that it be permitted to convey the leased premises and assign its rights in the lease agreement without any consent or approval of the tenant and without any ongoing liability for the performance of the obligations of the landlord under the lease. Such a provision may not be of great concern to a tenant where the lease agreement limits the liability of the landlord in any event to its interest in the property where the leased premises are located. A tenant will be vitally concerned with an assignment by the landlord, however, if the leased premises are being constructed or renovated and the landlord is supposed to pay all or part of the costs of such activities; the tenant in those situations will want to have the right to control the assignment of the landlord's interest in the leased premises until such costs are paid. If the landlord is otherwise entitled to assign its interest in the lease without the tenant's consent, the assignee should assume the liabilities of the landlord under the lease. If there is not a nonrecourse provision in the lease agreement, the tenant may also want to negotiate a provision under which the original landlord remains liable for the performance of the obligations of the landlord under the lease unless the tenant's consent to the assignment is obtained and the tenant has approved the creditworthy status of the prospective successor landlord.

Although such issue appears to be a matter of contractual negotiation only in many states, the Texas Property Code provides that tenants may not assign or sublease their rights under a lease of real property in Texas without the landlord's consent.[3] The landlord can grant such consent in specific instances or generically in advance, of course, so the relevant negotiation with respect to these issues involves the extent, if any, that the landlord will be required to grant such consent under

[3] See Section 91.005, Texas Property Code, as amended. The statutory provision is captioned "Subletting Prohibited" and states, "During the term of a lease, the tenant may not rent the leasehold to any other person without the prior consent of the landlord." The courts have construed the language of the statute to apply to both a sublease and an assignment by the tenant. See, e.g., Lawther v. Super X Drugs of Texas, Inc., 671 S.W.2d 591 (Tex.Civ.App.Houston [1st Dist] 1984).

specified circumstances or, at a minimum, not unreasonably withhold, condition or delay its consent.

A tenant will want the landlord to agree that its consent will not be required for an assignment to an affiliate or subsidiary, on the understanding that the tenant will not be relieved from liability for the obligations under the lease by means of such an assignment. It should be noted in this regard that the Texas Business Organizations Code, as amended, provides that a merger or other type of reorganization of a tenant entity does not constitute an assignment of its assets for purposes of requiring consent of other parties such as a landlord.[4]

A landlord will often argue that it must control assignments or subleases by tenants in order to control the tenant mix and quality in the subject property. In reality, however, the landlord is probably less interested in those objectives than it is in assuring that the tenant does not gain the benefit of any appreciation in value of its leasehold rights and that the tenant is not in competition with the landlord with respect to the lease of vacant space in the property by the landlord.

A landlord will sometimes permit a tenant to sublease or assign all or part of the leased premises on the conditions that the original tenant remain liable for the performance of all obligations under the lease by the sublessee or assignee and that all of the profits realized by the original tenant as the result of the sublease or assignment must be paid to the landlord. At a minimum, the original tenant will want to be reimbursed for all costs incurred in implementing the sublease or assignment, such as leasing commissions and refurbishment allowances. The original tenant may also try to negotiate a right to participate in some percentage of the profits on the sublease or assignment or, in the alternative, to be released from liability for the lease if the landlord insists on receiving all such profits.

Some leases provide that the landlord will be entitled to terminate the original lease and recapture the leased premises if the original tenant seeks to sublease all or part of the leased premises or assign all or part of the lease. The tenant may want to protect itself from an adverse result by retaining the right to withdraw its request for the landlord's consent to any such transaction if the landlord indicates that it will exercise its recapture rights. On the other hand, a tenant may want to negotiate a variation of such a provision under which the landlord is obligated either to consent to the tenant's proposed sublease or assignment or to exercise its recapture rights and relieve the tenant from further liability under the lease for the portion of the leased premises involved in such sublease or assignment. Most landlords will resist a tenant's efforts to obtain the ability to force the landlord into such a potentially undesirable dilemma of having to agree either to accept a tenant it may not want or to release the original tenant from liability on the lease.

A tenant will sometimes seek to negotiate parameters under which the landlord will agree to grant consent to a sublease or assignment to a sublessee or assignee that satisfies specified financial or other criteria. The tenant will want the landlord to be obligated not only to grant its consent to such a sublease or assignment but also to release the tenant from liability under the original lease with respect to the portion of the leased premises which is subject to the sublease or assignment. A landlord may agree to consent to the transaction itself without being required to agree to the release or modification of the original tenant's liability under the original lease.

A tenant that is operating a business in leased premises may attempt to negotiate a provision in the lease under which the landlord will be required to grant its consent to an assignment of the lease that is made in the context of the sale of the tenant's business. The landlord, however, will more than likely have the same concerns regarding an assignment of the lease in this situation as it would ordinarily have with any other assignment.

In some cases, a landlord will negotiate fiercely to preserve its rights to control subleases and assignments by the tenant but fail to consider the ramifications of a sale of the ownership of the tenant. This issue is particularly pertinent where the tenant is a single-purpose entity that can easily be transferred for the purpose of effecting what is in essence a transfer of the tenant's rights under the lease without having to obtain the consent of the landlord. Careful landlords, therefore, will insist that the lease provide that the consent of the landlord will be required for a transfer of the ownership of the tenant in the same manner that the landlord's consent would be required for an assignment of the lease or a sublease of all or part of the leased premises. It is not altogether clear how this situation would be impacted by the provisions in the Texas Business Corporations Act and Texas Business Organizations Code cited previously which state that a merger or other corporate reorganization will not be deemed to be an assignment of a lease. In other words, if a tenant which is a single-purpose entity is merged with another single-purpose entity owned by different owners, the restrictive provision in question would need to be examined to determine whether it encompasses such a transaction and, if so, whether the restrictive provision in the lease is enforceable in light of the statutory provisions which arguably override any such lease provisions.

11. SERVICES TO BE PROVIDED BY LANDLORDS.

With the exception of most leases of free-standing, single-tenant leased premises, it will usually be contemplated by the parties that the landlord will provide some level of services to the leased premises in addition

[4] See Section 10.008(2)(C), Texas Business Organizations Code, as amended.

to permitting the tenant to occupy those premises. Such services can include lighting, electricity for office equipment, heating and air conditioning, connections for telephones, restroom facilities, hot and cold water, elevators, parking, security personnel or systems, repair and maintenance personnel, lobby facilities and janitorial services. The landlord will ordinarily recoup the costs of providing these either as an increment of the base rent or as additional rent, as discussed previously.

Leases will generally provide for services such as heating and air conditioning to be provided as part of the base rent or additional rent only during specified hours of normal operation of the building. The tenant will want the landlord to make such services available during other hours at the cost of the tenant, with the tenant preferring that the cost which will be charged to be specified in the lease agreement itself. The landlord will usually agree to provide such services during non-normal hours of operation, but will prefer to retain the right to adjust the charges for such services to reflect cost increases experienced by the landlord in providing the services.

The tenant will want the lease to require that other services, especially electricity and building and elevator access, will be provided at all hours at no additional charge to the tenant. The tenant will also want to specify the frequency with which janitorial services will be provided, including the provision of day maid cleaning services in addition to thorough janitorial services in the evenings and/or on week-ends.

Of major concern to the tenant in most situations will be the amount of parking that the landlord is required to provide for the tenant's employees, suppliers and customers. In leases for professional service firms, issues such as reserved parking for the principals of the firm, designated visitor parking areas and ample unreserved parking capacity for the firm's employees will be matters of significant negotiation. As tenants have continued to increase the intensity with which leased space is utilized, with more employees being located in a given amount of leased space than had been the case in the past, the demand for available parking capacity has escalated commensurately. If on-site parking capacity is not available, the tenant may seek to negotiate an agreement under which the landlord will provide supplemental off-site parking within a reasonable distance from the leased premises and/or will provide shuttle service from the off-site parking facility to the leased premises. As noted previously, retail tenants will want to have some degree of control over the extent to which construction of additional improvements by the landlord in parking areas either restricts the visibility of or access to the tenant's leased premises or reduces the parking capacity that is available for the tenant's customers and employees within the areas originally designated for such parking.

An issue that is often quite contentious involves the consequences of an interruption in the provision of utilities and other services to the leased premises. The parties can usually reach agreement that a relatively brief interruption will not impact the leasing arrangement and that some form of rental abatement is appropriate if the interruption extends beyond such a minor period of time. Some landlords will resist any such abatement, however, especially if the interruption is due to causes beyond the landlord's control, including the effects of weather conditions such as hurricanes, tornadoes or freezes. A tenant will advance the contrary view that an abatement of rent is appropriate under any such circumstances because, among other reasons, the landlord can obtain rental loss insurance that covers the loss in revenues.

A tenant will also often contend that the tenant should have the right to terminate the lease entirely if the interruption in essential services continues for an extended period of time. A landlord will probably reiterate that the tenant should not be able to terminate the lease due to interruptions resulting from causes beyond the landlord's control and will note that such interruptions will often affect similar properties in the vicinity of the leased premises in the same manner as the leased premises are being affected. The tenant will counter that argument with the proposition that the failure to restore the essential services within some reasonable period of time can legitimately be construed as evidence of the likelihood that the services cannot or will not be restored to the leased premises in the foreseeable future and that, under those circumstances, the tenant simply has to be free to move its operations somewhere else.[5]

12. FINANCING ISSUES.

Both parties may have concerns that need to be addressed in the lease in connection with the financing which has been or may be obtained for the project.

The tenant may object to the landlord's having either a statutory or contractual landlord's lien on the tenant's personal property located on the leased premises because such liens might preclude the tenant from using such property as collateral for financing it needs for its business or otherwise impair the ability of the tenant to obtain such financing. The landlord may be willing to subordinate its landlord's liens to the security interests in the tenant's personal property which need to be granted to the tenant's lender, but the tenant's lender will usually not be satisfied with anything short of a complete waiver of the landlord's liens in order to avoid having a conflict with the landlord when the tenant's lender is seeking to

[5] The long-term consequences arising out of the tornado damage in downtown Fort Worth during 1999, including the abandonment of the Bank One Building for a number of years, as well as the widespread devastation of Hurricane Katrina in 2005 and Hurricane Ike in 2008, might be cited by the tenant as support for this argument.

obtain possession of the collateral and conduct a sale foreclosing its security interest. The landlord will be concerned with not having the ability to use the assertion of a landlord's lien to prevent the tenant from removing personal property from the leased premises during the existence of a default by the tenant under the lease, but there does not appear to be an obvious way to address that concern on the part of the landlord without impairing the ability of the tenant's lender to remove the personal property in the event of a default by the tenant on the financing. As a practical matter, the tenant will often be in default with respect to both such obligations if it is in default as to either one of them, so the possibility of such a conflict between the landlord and the tenant's lender does seem to be fairly high.

As noted earlier, the tenant will want to obtain a subordination, non-disturbance and attornment agreement from the landlord's lender which recognizes the continued right of the tenant to occupy the leased premises if the landlord defaults on its financing and the landlord's lender forecloses its liens on the property which includes the leased premises. Conversely, the landlord's lender will sometimes want to negotiate an agreement with the tenant under which the lender will be entitled to notice and opportunity to cure a default by the landlord before the tenant is permitted to exercise any offset or termination rights.

Leases customarily require the tenant to provide the landlord with estoppel certificates concerning the status of the lease from time to time as requested by the landlord in connection with the proposed financing or sale of the property in which the leased premises are located. It is less common for the tenant to have the right to obtain estoppel certificates regarding the lease from the landlord, but it is usually prudent to include such a provision in the lease that can be utilized if the tenant is required to provide such information to a prospective lender or buyer of the tenant's business.

13. REPAIRS AND MAINTENANCE.

The lease agreement needs to specify clearly which party has the responsibility to maintain and repair specific elements of the leased premises. A lease of a free-standing, single-tenant building will often provide that the tenant is solely responsible for all such repair and maintenance obligations. In the greater number of cases which involve leased premises that are portions of larger, multi-tenant buildings, the repair and maintenance obligations are usually divided between the parties and it is important to specify where one party's obligations end and the other party's obligations begin.

For example, a typical formulation will obligate the landlord to maintain and repair the exterior walls, roof and structural load-bearing elements of the building in which the leased premises are located and will obligate the tenant to maintain and repair the interior of the leased premises, including interior ceiling systems and lighting fixtures below the roof. Components which are not easily segregated by using such a structural vs. non-structural formulation and probably deserve specific treatment include exterior glass windows and walls, curtain wall systems, fire sprinkler systems, HVAC compressors located on the roof of the building and HVAC duct work located between the roof and the interior ceiling structure.

Landlords sometimes want the tenant not only to repair and maintain exterior glass windows and walls but also to insure such components against loss. Tenants will often agree to bear the burden of repairing and maintaining such glass components but resist the obligation to pay the relatively high cost of insuring against loss to such components.

Each party will ordinarily want the other party to be liable for the costs of repairing and maintaining components which are damaged by the other party, regardless of which party has the general responsibility for repairing and maintaining such components. Such provisions may be affected, however, by waivers of subrogation in particular circumstances.

Each party will also ordinarily want to have the right to exercise self-help remedies to address repair or maintenance issues for which the other party is responsible which are not resolved within a specified period of time after such conditions have been brought to the responsible party's attention and to recoup the costs incurred in exercising such self-help remedies plus interest.

14. RESPONSIBILITY FOR LEGAL COMPLIANCE

The types of compliance issues which can arise in connection with a commercial lease include zoning classifications, subdivision platting requirements, building and fire codes and permits, occupancy permits, architectural control regulations and other restrictive covenants, accessibility requirements, conservation controls, flood regulations, regulations pertaining to hazardous substances such as asbestos and lead and other environmental issues.

The lease agreement will need to make a clear allocation of responsibilities between the landlord and tenant for satisfying the applicable compliance requirements. For example, the landlord may be responsible for satisfying accessibility requirements which are applicable to all common areas of the property in which the leased premises are located and the tenant may be responsible for satisfying accessibility issues pertaining to the activities of the tenant within the leased premises.

15. INSURANCE OBLIGATIONS.

The lease agreement should specify the relative responsibilities of the parties for obtaining and

maintaining insurance with respect to the leased premises. In many cases, the landlord will be responsible for property insurance with respect to the building in which the leased premises are located and with respect to the leased premises, except for the contents of the leased premises, while the tenant will be responsible for insuring the contents of the leased premises. The parties will want to include a waiver of subrogation clause in all such insurance coverages and to assure that such waivers of subrogation do not adversely affect insurance coverages.

Each party will ordinarily maintain liability insurance with respect to its activities on or with respect to the leased premises and will include the other party as a named insured in such insurance policies.

A tenant may want to negotiate an agreement with the landlord's lender under which the lender will permit insurance proceeds to be used to reconstruct the leased premises rather than being applied to reduce the landlord's debt, either in general or in specified circumstances.

16. CASUALTY AND CONDEMNATION ISSUES.

The occurrence of a casualty or condemnation event gives rise to a number of issues that the parties will want to address in the lease agreement. The primary issue in each instance involves the extent, if any, that the landlord, in the case of a multi-tenant property, or the tenant, in the case of a free-standing, single-tenant facility, is required to rebuild the leased premises following such an event; or, conversely, the extent, if any, to which either party can terminate the lease by reason of the occurrence of such casualty or condemnation event. Many leases, for example, permit the landlord to terminate the lease if the event occurs within a relatively short period of time before the normal expiration of the lease or if the rebuilding process will require more than a specified period of time or amount of money. A tenant may be concerned that the landlord will take advantage of such a termination provision to terminate the tenant's lease and rebuild the leased premises for lease to another tenant for a higher rental rate. If such a possibility is sufficiently important to the tenant, the tenant may want to suggest that the tenant should have an option to release the leased premises on the same terms and conditions as were contained in the original lease if the landlord initially terminates the lease but subsequently elects to rebuild the leased premises within a specified period of time thereafter. A tenant may also ask for a right to avoid a termination by the landlord if the casualty event occurs toward the end of the lease by exercising an option to renew the lease if one is available at that time.

If an obligation to rebuild the leased premises is imposed on either the landlord or the tenant under specified circumstances, then the parties will also need to provide for the manner in which the proceeds of casualty insurance or condemnation award are going to be used for such rebuilding. The party which is not responsible for the rebuilding will want to assure that the funds are disbursed to the responsible party in a manner commensurate with the progress of rebuilding, and may suggest the use of a third-party escrow agent and disbursement procedures similar to those for a construction loan. The non-responsible party will also want to assure that the responsible party provides any funds which are required in addition to the insurance or condemnation proceeds to complete the rebuilding and may require either that security for such funds be provided or that those funds be advanced for rebuilding costs before the insurance or condemnation proceeds can be utilized by the responsible party for paying such costs. Both parties will want to assure that any relevant mortgagee agrees that the insurance or condemnation proceeds will be made available for rebuilding if such rebuilding is required under the lease agreement. A variation on this last theme may involve a contention by the responsible party that it should not be required to accomplish the rebuilding to the extent that the mortgagee refuses to make such proceeds available for such purpose.

The landlord will typically insist that the lease agreement provide that the landlord is entitled to all proceeds of a condemnation event involving the leased premises which are not required to be used for rebuilding the premises and that the tenant is required to pursue a separate action to obtain the value of its leasehold interest in the premises. The tenant, on the other hand, will want to have any such excess proceeds apportioned between the value of its leasehold interest and the residual value of the landlord in the leased premises after the term of the lease has expired.

The mortgagee of the party entitled to receive any excess insurance or condemnation proceeds that are not utilized for rebuilding the leased premises will usually insist that such excess proceeds be applied to such party's mortgage debt.

17. DEFAULTS AND REMEDIES.

Many leases have extensive provisions defining what types of events will constitute a default by the tenant and specifying what remedies the landlord can pursue in such circumstances. It is not as common to find leases that accord the same sort of treatment to acts of the landlord, although the landlord clearly has obligations under the relevant lease that it may fail to perform. The better practice seems to be to address these issues with respect to both parties to the lease agreement.

Each party will want to receive notice of any default and to have an opportunity to cure the default. Landlords are often reluctant, if not adamant, when asked to provide notice and opportunity to cure a late payment of base rent or of additional rent which has been prescribed in advance. In some situations, the landlord will agree to provide notice and opportunity to cure such late

payments, but only in a limited number of instances during an individual period of time, such as a calendar year. Some landlords may agree to a grace period for late rent payments in instances where notice and opportunity to cure are not required, but other landlords refuse to permit any such grace periods. Each party will insist on receiving notices of defaults other than late rent payments and an opportunity to cure such defaults for a reasonable period of time. The opportunity to cure such a non-payment default will often be available to the defaulting party for a specified minimum period of time, plus additional reasonable time subject to a specified maximum period of time in which to cure defaults that can be cured but cannot reasonably be cured within the minimum period of time. Obtaining the benefit of such additional cure periods will usually be conditioned on the defaulting party's having commenced to cure the matter within the minimum cure period and continuing to pursue the curing of such matter thereafter with diligence and in good faith.

Each party's lender may request the other party to agree to grant the lender additional notice and opportunity to cure defaults by its debtor that will be available to the lender after the debtor party has failed to cure such matter within its own cure period. More typically, though, a lender will be satisfied with the right to receive notices of default concurrently with its debtor party and an opportunity to cure such defaults which is concurrent with the cure period which is granted to the debtor party; the lender will want to have a separate right to receive notice and opportunity to cure defaults where the other party is not required to provide such notice and opportunity to cure to the debtor party.

Occasionally, one will encounter a provision in a lease which says that a party is obligated to provide notice and opportunity to cure to the other party and its lender, but that the party which is obligated to give such notice and opportunity to cure is not subject to any liability if the notice and opportunity to cure are not given. It is not altogether clear why a person would ever suggest, or certainly agree to, such a provision in the context of explicit negotiations of an obligation to provide such notice and opportunity to cure.

Leases contain a variety of remedies that can be pursued by a party if an event of default has occurred with respect to the other party to the agreement. The landlord will almost invariably resist a suggestion that the tenant should have a right to offset its claims against the rent that is otherwise payable under the lease. The landlord's mortgagee will support such a position by the landlord, at least with respect to rent payments necessary to pay debt service payments and probably with respect to all rent payments. The tenant will argue, on the other hand, that the absence of a right of offset renders other self-help remedies much less useful because of the virtually prohibitive costs of initiating and pursuing lawsuits to collect relatively small amounts of money expended in exercising such self-help remedies. The lease should contain a provision allowing the prevailing party to recover attorneys' fees, though, which may level the playing field somewhat.

For almost a century the law was clear in Texas that a landlord did not have a legal obligation to mitigate damages in the event of a default by the tenant. In 1997, however, Texas joined the majority of states in imposing such a mitigation obligation on landlords.[6] Although the Texas Supreme Court seemed to leave open the possibility that the parties could agree to waive such mitigation obligation in the lease agreement[7], the Texas Legislature subsequently enacted a statutory provision providing that such a waiver would be void.[8] It is relatively common to see provisions in leases now that specify in detail what kinds of actions a landlord is expected to take in order to satisfy such mitigation obligation. Leases exist in which reasonable efforts on the part of the landlord to relet the subject premises are described in terms such as the following, although the author is not aware of any cases in which such provision have been approved:

(a) The landlord may elect to lease other available space in the project, if any, before reletting the premises.
(b) The landlord may decline to incur out-of-pocket costs to relet the premises, other than customary leasing commissions and legal fees for the negotiation of a lease with a new tenant.
(c) The landlord may decline to relet the premises at rental rates below then prevailing market rental rates.
(d) Before reletting the premises to a prospective tenant, the landlord may require the prospective tenant to demonstrate the same financial wherewithal that the landlord would require as

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[6] See, Austin Hill Country Realty, Inc. v. Palisades Plaza, Inc., 948 S.W.2d 293 (Tex. 1997).

[7] Ibid., at 299.

[8] Section 91.006(b), Texas Property Code, as amended. Section 91.006(a) of the Texas Property Code speaks in terms of a duty on the part of the landlord to mitigate damages only where the tenant abandons the leased premises, so an argument can be made that the prohibition on contractual waivers in Section 91.006(b) is limited to that type of default by a tenant and may not extend to other types of defaults by a tenant.

a condition to leasing other space in the project to the prospective tenant.

(e) The landlord may elect to consent to an assignment or sublease by an existing tenant of the project before reletting the premises.

(f) The landlord may decline to relet the premises to a prospective tenant, the nature of whose business may have an adverse impact upon the manner in which the project is operated or the high reputation of the project even though in each of said circumstances such prospective tenant may have a good credit rating.

(g) The landlord may decline to relet the premises to a prospective tenant if the nature of such prospective tenant's business is not consistent with the tenant mix of the project or with any other tenant leases containing provisions against the landlord leasing space in the project for certain uses.

(h) Listing the premises with a broker in a manner consistent with parts (a) through (g) above constitutes reasonable efforts on the part of landlord to relet the premises.

Landlords often insert provisions in their standard lease agreements stating that the landlord's obligations can only be enforced against its interest in the leased premises and possibly its interest in the larger property of which the leased premises are a part. Where a landlord owns a number of assets, this type of non-recourse provision may be of significant concern to a tenant. In the current real estate development and financing environment, however, most properties are owned by single-purpose entities that provide essentially a non-recourse remedy to the tenant whether or not the lease agreement specifically limits the tenant's remedies in that respect.

Some leases provide that disputes between the parties are to be resolved by arbitration. It is the author's view that arbitration has not met the expectations of either the real estate industry or the legal profession with respect to savings in time or expense. Moreover, the risks presented by resorting to a system where the arbitrator's decision is virtually unassailable and there is no right of appeal as a practical matter have only recently begun to be appreciated by these groups. As an alternative, many leases now contain a waiver of trial by jury, which may achieve the objectives of the parties more effectively than arbitration. Such waivers of trial by jury have been held to be enforceable.[9]

[9] See, In re Prudential Ins. Co. of America, 148 S.W.3d 124 (Tex. 2004), holding that waivers of jury trial in a lease and lease guaranty were enforceable.

18. TEXAS MARGIN TAX CONSIDERATIONS.

The new Texas margin tax gives rise to two principal problems in connection with landlord-tenant relationships and lease agreements.

One issue that is now commonly included in negotiations between commercial landlords and tenants is whether the margin taxes payable by the landlord on the rents received under the lease should be treated as reimbursable pass-through costs or as non-reimbursable income taxes. Most major tenants refuse to reimburse the landlord for the margin tax on the grounds that it is an income tax. Even if one concedes the merit of that position with respect to the profit element included in the base rental rate, it could be argued that it would be equitable to gross-up any element for pass-through costs included in the base rental rate to reflect an increment for the margin tax, because those pass-through costs have no profit aspect in them. (The formula would be inexact, of course, because of the ratcheting-up effect of the tax-on-a-tax effect.) A variation on this argument would be that the tenant should reimburse the landlord for the margin taxes payable with respect to the rent to the extent that the property taxes on the leased premises are subsequently reduced, which was a major rationale for the margin tax in the first place. This argument has also not received widespread support.

Another issue involves Section 171.1011 of the Texas Tax Code, which requires landlords to report gross rental income including pass-through expenses instead of net rental income after deducting pass-through expenses in calculating total revenues for purposes of the Texas margin tax. [10] The principal expenses that are pertinent with respect to this issue include ad valorem taxes, insurance premiums and common area maintenance and operating expenses. The practical problem is that the amounts paid by the tenant to the landlord as reimbursement for the tenant's share of these costs are included in the landlord's income for purposes, but the expenses are not deductible by the landlord. Consequently, even though the landlord derives no net income from the reimbursements, the landlord has to pay a margin tax on the reimbursement amounts. The net effect is that the landlord has to pay the margin taxes out of the landlord's pocket and the reimbursements result in a net deficit to the landlord.

It seems theoretically possible to devise a new type of pass-through arrangement for commercial leases pursuant to which the tenant pays expenses directly in a manner that does not result in the reimbursements being reportable by the landlord. As a practical matter, a system in which the tenant pays the expenses directly for the account of the landlord seems likely to be challenged by the Comptroller of Public Accounts as a subterfuge. In

[10] See also, Comptroller of Public Accounts Rule §3.587, 34 TAC Part 1, Chapter 3, Subchapter V, §3.587.

order to succeed, therefore, this effort must seemingly make the expenses those of the tenant and not expenses of the landlord that are just being paid by the tenant. With respect to ad valorem taxes and common area maintenance and operating expenses, such an effort seems all but impossible. Those expenses are by their very nature those of the landlord and one struggles to identify a means of shifting the responsibility for them to the tenant. It is conceivable that an arrangement for shifting the risk of loss and insurance responsibility from the landlord to the tenant could be devised, but it is doubtful that either the landlord or the landlord's lender would be agreeable to the landlord's relinquishing control over that vital function to a group of tenants with several responsibility for assuring that the leased property is properly insured.

At this time, the author has not identified a readily acceptable solution to these problems. It is unfortunate that the Legislature did not address this issue in an equitable manner in the most recent session. Hopefully, the issue will be resolved in the near future either by astute analysis and planning or by legislative action.

19. TEXAS REAL ESTATE FORMS MANUAL LEASE FORMS.

Chapter 71 of the Texas Real Estate Forms Manual (Second Edition, 2014, State Bar of Texas) is devoted entirely to leases. Included in the chapter are complete forms for nine different types of leases: basic, retail, office, residential, industrial, hunting, agricultural, grazing and manufactured home community. Also included are three dozen or so alternative or additional clauses and forms.

Each of the form leases included in Chapter 71 sets forth the same basic generic terms and conditions, so that it will not be necessary to look elsewhere for those provisions in compiling a proposed lease agreement. Each of the form leases (except for the basic lease) also contains specific provisions designed to address the circumstances most commonly encountered with respect to that particular kind of lease. It is understood that the objective of the SBOT Real Estate Forms Committee in connection with these and other forms in the Manual is to provide prepared forms that will address issues that might arise in connection with at least 80% of the situations where the forms may be used. Many of the other issues can be addressed with the use of the alternative and additional clauses and forms in Chapter 71 of the Manual.

20. CONCLUSION.

A commercial leasing arrangement can involve some of the most complex types of legal and economic issues of any kind of contractual relationship between parties to a real estate transaction. The list of issues addressed above is by no means exhaustive and the discussion of each of these issues that has been presented only summarizes some of the considerations that the parties may take into account in negotiating and evaluating these issues. It is hoped, however, that this overview will be of assistance to the reader in placing the other presentations during this course in a more meaningful perspective.