



# ROCKVILLE

ECONOMIC DEVELOPMENT, INC.

MARYLAND

In the Business of Connection



## COMMERCIAL LEASE TOOLKIT

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# *City of Rockville*

# COMMERCIAL LEASE TOOLKIT

**Rockville Economic Development, Inc. (REDI) is here as a resource for Rockville businesses to navigate many of their challenges.**

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REDI hosts the Maryland Women's Business Center (MWBC), which can provide technical assistance to any business owner that needs support with topics like development of a business plan, marketing, and access to capital. MWBC is a program in partnership with the Small Business Administration (SBA) and one-on-one counseling with our experts is free. There are also many workshops available for no or low cost.

➤ **Please check out [www.marylandwbc.org](http://www.marylandwbc.org) for more information.**

REDI also provides businesses with help finding real estate locations, navigating governmental processes, and connecting businesses with market data, resources and contacts. Your business may also be eligible for Rockville and/or Montgomery County incentive programs.

➤ **Please contact [Richelle@rockvilleredi.org](mailto:Richelle@rockvilleredi.org) for more information and check out [www.rockvilleredi.org](http://www.rockvilleredi.org).**

This toolkit is designed to assist you in understanding many of the key lease negotiations you may want to understand before entering into a lease agreement. The law does not afford commercial tenants the level of protection and fairness afforded to residential tenants. For most issues, the landlord's and tenant's rights and obligations are determined solely by the lease. We suggest that you have an attorney assist you with negotiations, and it is also very helpful to have a commercial real estate broker help you negotiate. You are likely to get better terms and limit your exposure if you employ professionals in the beginning, before you commit to a contract.

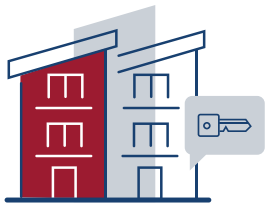
## **When to Employ Professionals**

We recommend scheduling a consultation with an attorney before selecting a space. An attorney can provide insight into the issues discussed in this toolkit, questions to ask the real estate broker and landlord, provisions to be negotiated at the term sheet or letter of intent stage, and when to engage space design and construction professionals for inspections.

*Please note that THIS IS NOT LEGAL ADVICE.*



# Economic CONSIDERATIONS



## Rent

Monthly payments to the landlord usually consist of at least three separate components: Annual Base Rent, Taxes, and Operating Expenses, each of which are discussed below.

When considering space (also referred to as premises), it is important to understand and budget for all three components, in addition to other Extra Costs discussed below.

**Annual Base Rent:** Base rent is usually a fixed amount per square foot (sf) of the premises calculated as an annual amount – but paid monthly. **An example: \$24 per square foot for 1,500 sf = \$36,000 for the year, and \$3,000 monthly. Base rent will usually increase annually by a pre-negotiated amount.**

**Operating Costs and Taxes:** Operating Costs (sometimes called operating expenses or common area costs or expenses) are the landlord's costs for managing, operating, and insuring the property and for services provided to the building, such as HVAC. Taxes consist of taxes and other assessments payable by the landlord on the land, property, governmental services to the property and surrounding vicinity, and sometimes rents.

When negotiating a letter of intent, add the per square foot amount of operating costs and taxes to base rent to understand the full monthly amount payable.

It is critical to understand that operating costs and taxes may be different from year to year, and the amount may not be known in advance. The monthly payment is usually an estimate of actual costs. If the Landlord's estimate is too low, the tenant may owe an additional amount once the Landlord knows and reconciles actual costs. Having a reserve fund can help manage the unforeseeable nature of the charges. Your real estate broker may also be able to negotiate limitations on operating expense increases.



## OPERATING COSTS AND TAXES

**An example: If initial operating expenses are \$5 per square foot and taxes are \$4 per square foot, when added to the \$24 per square foot of Base Rent in the above referenced example, the total monthly payment is \$4,125 as follows:**

Base Rent	\$3,000.00
Operating Expenses	\$625.00
Taxes	\$500.00
Total	\$4,125.00

*Be sure to also account for the other Extra Charges (noted on page 3) if applicable.*

Operating expenses and taxes are paid as a percentage share of the amount the landlord incurs annually. If you are leasing space in an office building these costs may be “grossed up” so that the Annual Base Rent includes them for the first year and increases over that base first year would be billed as an additional charge in subsequent years. The percentage share is usually the square footage of the premises divided by the square footage of the building, the square footage of all buildings at the property, or the square footage of spaces that are leased and occupied. If the calculation is based on the square footage of spaces that are leased and occupied, this means the remaining tenants (instead of the landlord) cover costs that would have otherwise been paid by the tenant of a vacant space. For a tenant, the goal is to have the denominator in the percentage share calculation as large as possible. Speak with your real estate broker and attorney about negotiating this.

For office buildings, the landlord will likely only provide HVAC during working hours, so there may be an additional charge if needed after hours.



## OTHER EXTRA CHARGES AND ADDITIONAL FEES

In addition to Operating Expenses and Taxes, tenants should budget for incidental costs, some of which are listed below. Some costs are payable to the landlord and some are payable to the service provider or governmental authority.

- |   |  |  |
|---|--|--|
| • Insurance (liability, environmental, property, worker's compensation, employer liability, etc.) | • Utilities  | • Accounting and Legal Fees                        |
| • Signage   | • Personal Property Taxes  | • Point of Sale System                             |
| • Permitting Fees   | • Rent tax   | • Security Monitoring                              |
| • Cleaning – Interior   | • Maintenance and Repair Costs ( <i>discussed on page 4</i> )        | • Salaries, Benefits, and Payroll Taxes            |
| • Window Cleaning   | • Merchant Association – Mandatory Advertising and Promotional Costs | • Parking Fees                                     |
| • Trash   | • HVAC Service Contract (if the premises has its own units)          | • Extermination and Pest Control                   |
| • Water/Sewer   |  | • For certain restaurants, grease trap maintenance |

All charges under a lease are usually called “additional rent”, which allows Landlord to pursue eviction for non-payment using streamlined eviction processes for failure to pay rent. Generally, a tenant is not permitted to withhold rent during a dispute with the landlord – but may get a court agreement to receive rent payments while a dispute is being adjudicated.

## Tenant Allowance

**Sometimes the tenant can negotiate some funding up front from the landlord to make improvements to the premises.**

The work might either be done by the landlord or funds may be provided to the tenant for the tenant to do work. When there is an allowance for work, the landlord will amortize that amount over the term of the lease and add it to the monthly base rent, so they are paid back for this investment. Landlords usually have an approval right over plans to alter the premises interior or exterior. Evaluate whether the landlord should perform the desired work or whether tenant should be responsible. There are pros and cons either way. One positive of negotiating for the landlord to perform the work is that they will generally be responsible for cost overruns and unforeseen code compliance requirements.



## Maintenance Charges/ Required Alterations and Improvements/Impact Fees

**The tenant may be responsible for certain maintenance, repair, and replacement costs, including the cost of bringing the structure in compliance with building and zoning codes.**

This may include any storefront upgrades, signage, HVAC maintenance and replacement, fire alarm and sprinkler, plumbing and electrical. Typically, the landlord will agree to cover the roof, structural, and building systems up to the point they come to the premises. Tenants should have a full inspection of building systems by licensed professionals who specialize in building design and construction prior to signing the lease if they will be responsible for them. This usually includes an architect, engineer, or general contractor. If a system like HVAC is not in good shape or if the structure or fire safety system is not in compliance with building or zoning codes, the leverage for negotiations for repairs or replacement is prior to signing the lease. A tenant should not accept a premises until it is in the condition that the landlord promised to deliver or there is an agreed upon punchlist for the landlord to still perform.

If the premises is in a newly constructed or renovated building or if there is an expansion of utility services or building capacity, tenant may be required to pay impact fees in connection with securing building permits or a use and occupancy permit. Impact fees cover the cost of public infrastructure needed to accommodate the development or expansion and can be tens of thousands of dollars for a 2,500 square foot space. **The government agency that levies impact fees varies in each jurisdiction.\***



### IMPACT FEES

**Tenant should confirm if the Transportation Improvement Fee applies. This fee is charged by the County and applied to development.**

- **\*See [www.montgomerycountymd.gov/DPS/fees/Taxes.html](http://www.montgomerycountymd.gov/DPS/fees/Taxes.html) for more information on Montgomery County fees.**



- **Security Deposit.** A landlord may require a security deposit to secure tenant's obligations under the lease and can be used to offset any nonpayment of rent or failure to fulfil an obligation by the tenant. Usually a security deposit is not returned until the term has expired and the tenant has moved out.
- **Tenant Guaranty/Letter of Credit.** The landlord may request a tenant guaranty, especially if you have a new business. The landlord is interested in making sure that there are assets that back up the promise to pay the rent and other charges under the lease. Giving a personal guaranty may pledge a tenant's personal assets for the contractual obligation. This means, a landlord could take your personal savings or force you to sell your assets and liquidate personal investments to cover rent if there is a default under the lease and the landlord prevails in court. The landlord can also seize a portion of your wages. A tenant may want to try to negotiate a limit on the guaranty or for the guaranty to "burn off" over the course of the term. Having a guaranty burn off can be helpful if you need other funding that would be required to be backed by these assets. It is advisable to discuss the impact of giving a guaranty with your accountant, tax preparer, and attorney prior to signing. It is also possible that you could substitute a guaranty with a letter of credit, but the letter of credit will also have to be backed by assets that are tied up while it is active.
- **Late Charge.** The tenant may be required to pay a late charge if rent is not paid on time.
- **Broker Fee.** If there are brokers on the deal, it is important to clarify who pays the broker fees.
- **Lag Time and Adequate Reserves.** It is important to have a conservative schedule of the amount of time needed to secure permits, perform construction, and commence operations in the premises. This takes gathering information from your contractors, architect, real estate broker, and attorney on the amount of time it takes to secure permits and perform desired and required construction or alterations. If the landlord does not provide a contingency for rent commencement, it is important to have adequate financial reserves to cover rent owed before the tenant can lawfully move into the space and commence use. If construction will not start immediately, a tenant may want to negotiate a delay in taking possession of the premises, to avoid carrying costs such as insurance, HVAC service contract, and similar obligations, before the tenant can commence construction.



# *Term &* **TERMINATION**

## **Rent Commencement/Rent Abatement**

Rent sometimes will commence after the lease starts, so that the tenant has a period of time to get work and permitting done. Calculating enough time for this process is important, or the tenant may have to start paying rent before they are legally allowed to operate in the premises. The landlord may also incentivize a deal by providing a rent abatement period in the lease. This will allow a tenant to open and start operating, deferring some of the rent costs. The abatement value is typically made up of a longer lease term or slightly higher rent over the months that rent will be paid. If there is an abatement period, moving into the premises, performing work in the premises, or moving equipment or other property into the premises before the official move in date or while the landlord is performing construction may start the abatement period. Tenant's should negotiate whether all rent abates or just base rent. Be mindful of this and carefully evaluate the lease for guidance when deciding when to take these actions.

## **Termination**

The landlord and tenant may negotiate circumstances when they can terminate the lease early. The parties might want this right if the property is significantly damaged and is very costly to repair or there is little term left. Landlords also can usually default tenant and possibly terminate if the tenant becomes bankrupt or unable to pay its debts. For any right to terminate, evaluate whether and how Tenant will be compensated for improvements to the premises funded by Tenant. Compensation is not usually available if termination is due to default; however, in other instances, Tenant may be able to negotiate compensation.

## **Renewal Options**

Sometimes a Tenant may negotiate an option to renew the term either on a market rate at the time of renewal (which means the landlord and tenant will negotiate the new rate), or a predetermined rate. Negotiating a predetermined rate may provide more certainty for financial planning.







## Delivery of Possession

The lease may not have a hard deadline for the landlord to complete required work or deliver the keys, and Tenant may not have recourse if the landlord delays. It is prudent to negotiate a deadline and remedies available to the tenant if landlord does not timely complete work or deliver the keys.



## Holding Over

A tenant that refuses to vacate at the end of the term is considered as holding over, and may be subject to damages that the landlord incurs, and there may be a penalty in the lease. Therefore, a tenant should not hold over without landlord prior knowledge and written and signed permission.



## Lease Commencement

The lease will specify when the lease term starts. This will likely be when the landlord's work is complete in the space and the tenant may take position to move in or to start the work that tenant will do.

# *Use, Care and* **REPAIR OF PREMISES**

## **Permitted Uses/Exclusive Uses**

Whether the premises can be used as desired is governed by (i) the lease, (ii) zoning and land use laws and regulations; (iii) declarations, bylaws, covenants, deeds of trust, and restrictions recorded in land records; and (iv) other agreements between the landlord and other parties.

Zoning and land use laws and regulations and land records are publicly available, and the lease will usually require the tenant to assume responsibility for verifying that the desired use is authorized. Tenant may want to negotiate for a better position on this issue. It is also important to make sure that all uses are authorized in the lease and not prohibited by other agreements to which the landlord is a party so that the tenant is not prohibited from operating an essential part of its business, prohibited from selling products it intends to sell, or required to pay rent on a space it cannot fully use as desired.

Sometimes landlords provide an exclusive use to a tenant for a property. For example, there may be a bakery in a shopping center, and all other tenants in that center may be prohibited from selling baked goods. It is important to clearly negotiate what uses you are allowed to have or not have for the premises.

## **Alterations**

Tenants usually must have prior plan approval from the landlord before making alterations to the premises. The tenant retains ownership of personal property – but improvements that are affixed to the premises such that damage would be caused by removal, generally become part of the leasehold, and are owned by the landlord at the end of the lease – and should not be removed without landlord prior approval. It is helpful to put in writing what alterations, equipment, and property that the tenant is permitted to remove at the end of the lease.

## **Care**

Most repairs inside the premises are the obligation of the tenant. The tenant is responsible for any improvements it makes, as well as for the tenant's personal property. Landlord's typically have a right to enter the premises and make repairs, inspect, or show the premises to prospective tenants. The tenant may want to negotiate the notice and times for this.





## Rules and Regulations

The landlord may have rules and regulations that govern the property. The tenant needs to be familiar with these. Also, the tenant may want to place limitations on Landlord's ability to impose rules that materially increase the tenant's costs or obligations or place limits on tenant's rights. For instance, rules may allow the landlord to govern how a sign looks and whether it is backlit. A backlit sign costs significantly more than one that is not backlit.

## Common Area/Parking/Redevelopment

Common areas and facilities are provided for the non-exclusive use of tenants and their customers, employees, etc. However, the landlord should be responsible for cleaning, maintenance, and repair of the common areas, including timely removal of snow and ice, and pre-treatment of, sidewalks, drive areas, and parking lots. Sometimes a tenant can negotiate exclusive use of certain parking spaces. Landlords usually retain the right to alter common areas. If any aspect of the project was a major consideration in deciding whether to accept the base rent rate or whether to select the premises in general, consider negotiating to prevent changes to that element or to provide recourse if the landlord makes changes that adversely affect your use, business, access, or visibility.



# INSURANCE

## Commercial General Liability/Auto Liability

**Commercial general liability insurance covers the tenant for claims brought against the tenant for its actions, omissions, and breaches of contract.**

The tenant should make sure it obtains coverage in an amount required by the landlord. The landlord will usually ask to be an additional insured on the policy. This requires an endorsement from the insurance company and is reflected on a certificate of insurance naming the landlord as an additional insured.

The tenant should make sure its insurance policy also covers its personal property in the premises and the tenant improvements.

Leases often provide that tenant's failure to obtain required insurance may allow the landlord to obtain the insurance for them and charge the tenant the cost of that insurance as additional rent.

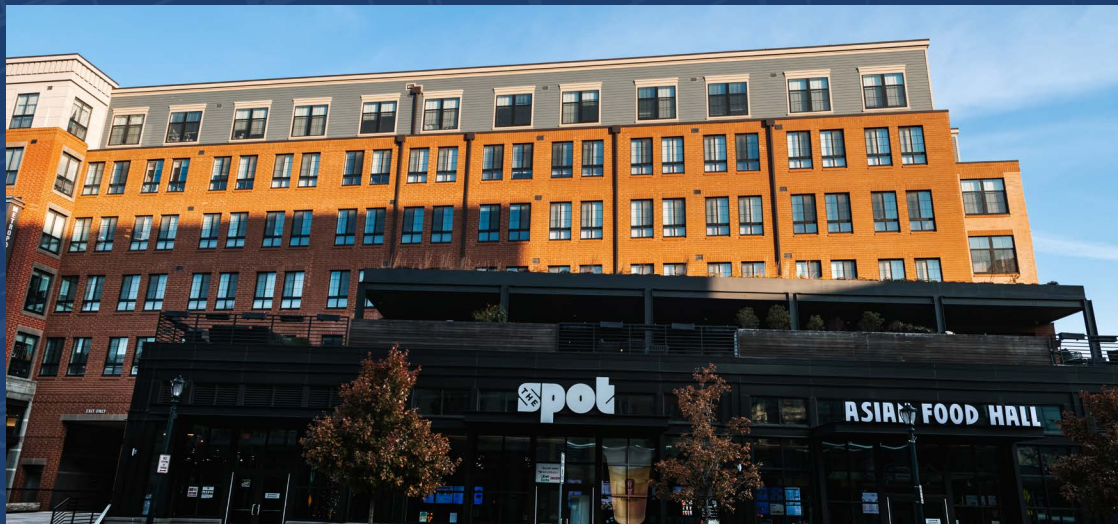
## Business Interruption Insurance

A landlord will require that a tenant have insurance to cover injury and property damage at the premises. In addition, the tenant should obtain business interruption insurance to cover the risk of a situation where the tenant must pay rent but may not have use of the property. An example of this might be if plumbing to a premises is damaged so that the tenant cannot operate for a few weeks.

## Indemnity

An indemnity clause is where one party agrees to pay for damage caused by the other. This is generally for the purpose of determining whose insurance policy will respond to a claim. It is important to make sure that this clause aligns with the insurance clauses. For example, if a visitor to the premises was injured in the premises, it would be tenant's obligation to provide a legal defense and pay any judgement that would be rendered against the landlord.





## Worker's Compensation

Tenants should carry workers compensation insurance as required by law. This protects the tenant against losses from injuries to its employees.



## Product Liability/Alcohol Liability

Tenants who serve food and/or alcohol may be required to have product liability and/or alcohol liability insurance, as applicable.



## Tenant Contractors

The tenant should make sure any contractor doing work on the premises has liability insurance, auto liability insurance, and worker's compensation insurance.



# Other Lease PROVISIONS

There will be a number of other lease provisions that should be reviewed with your attorney and broker. Here are a few key clauses:

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**Construction Permit Delays, Use and Occupancy Permit\*, Land Records and Restrictions.** Delays in construction permits, failure to have the permits necessary to lawfully operate in the premises, and restrictions recorded in land records can all result in being liable for rent under the lease without the ability to construct or use the premises as desired. It is important to have a space development team and attorney to help with the necessary due diligence. In Rockville, the Department of Community Planning and Development Services may also have helpful resources.

**Assignment.** Typically a tenant is not allowed to assign or transfer the right to operate in the premises to someone else without the landlord's consent. If the tenant intends to sublet portion of the space, it should negotiate the arrangement with the landlord as part of the permitted use.

**Relocation.** A landlord may have a right in a lease to relocate the tenant. The tenant should make sure that relocation is to an acceptable space, and that costs of relocation and build out are covered by the landlord.

**Property Insurance.** The lease should allocate who is responsible for property damage, regardless of fault. Tenant's liability insurance is not typically enough to cover major building damage, and it may not cover damage to the premises at all. To address this, the landlord should be responsible for insuring the landlord's property, including the building and all improvements other than those funded or installed by the tenant, and tenant should be released by the landlord and its insurance company for such property damage which is required to be covered under the landlord's property insurance policy. This is called a release and waiver of subrogation.

**Rent Acceleration and Mitigation.** A landlord may have a right to require all rent due for the remainder of the term to be paid at one time, in advance, after a tenant default. Additionally, Tenant may continue to owe rent after being evicted for a default. Tenant should speak with an attorney about negotiating a better position.

**Landlord's Lender's Rights (Subordination and Non-Disturbance).** The landlord's lender may have a right to terminate the lease or landlord's obligations under the lease if the landlord defaults on its mortgage. Also, a landlord's obligation to honor free rent periods, improvement allowances, landlord's work, and similar incentives, may be conditioned upon the approval of the landlord's lender. If Tenant is funding significant construction

*\*Also known as a certificate of occupancy.*



to the premises or is relying upon incentives from the landlord that may require lender approval, it is important to negotiate to protect tenant's interest from the rights of the landlord's lender. This may include entering into a subordination and non-disturbance agreement directly with the landlord's lender, or with respect to incentives from the landlord, negotiating alternative options such as a right to withhold rent or obtaining lender consent.

**Restoration.** The lease may require the tenant to restore the premises to its condition at delivery of possession, at the end of the term. Tenants may want to negotiate to avoid this. Restoring the premises may be costly.

**Landlord Default/Prevailing Party/Attorney Fees.** Leases may state that tenants cannot terminate in connection with a landlord default or that the landlord must be in default for 30 days before remedies are available to the tenant. For issues where a 30-day delay may be catastrophic, Tenant may want to negotiate an immediate remedy. Tenants can also negotiate in the lease for the landlord to pay tenant's legal fees if tenant wins in court. This can sometimes deter landlords from taking actions contrary to the lease or encourage good faith negotiations of lease disputes.

**Quiet Enjoyment/Material Changes/Interference with Use/ Constructive Eviction.** As a starting point, commercial leases usually require tenants to waive rent abatement, monetary recovery, and termination rights associated with interference with use, access, or visibility or other material changes to the building or project. Tenants will want to negotiate rent abatement for disturbances such as those associated with redevelopment that will not be covered by business interruption insurance.

**Hazardous Materials.** Tenant should ask the landlord to provide a copy of any existing environmental reports and negotiate to have the landlord responsible for existing environmental hazards, which may be hazards resulting from prior uses or things such as mold, lead, and asbestos.

**Pest Control and Other Nuisances.** For properties with food uses, it is important to negotiate a mechanism through which the landlord is responsible for insuring regular extermination and pest control. If your space or use is sensitive to noise, consider negotiating an obligation for the landlord to control noise levels from neighboring spaces. This is also a consideration when deciding to lease a particular space.

**Landlord's Lien.** Landlord's will usually be allowed to keep the tenant's property if tenant is in default. The property may either be used by a subsequent tenant or sold to satisfy rent. If Tenant is funding the property with a loan, the loan may require the landlord to waive these rights. Tenants have most leverage to obtain the waiver at the lease negotiation stage.



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