LEGAL EAGLES SOUND OFF ON LEASING NEGOTIATIONS

While most industry players realize and appreciate that the commercial real estate industry has evolved dramatically post-recession, what many don't grasp is that oftentimes the laws governing this industry change too. Many of these changes involve leases and the ever-tricky dance entered into by landlords and tenants.

Below are two perspectives — one macro, one micro — on just how important it is to consider the clauses in your lease to ensure you're the one ultimately leading the dance.

THE CHANGING FACE OF COMMERCIAL REAL ESTATE LAW IN THE 21ST CENTURY

By Daniel B. Myers and C. Gregg Ankenman

C. Gregg Ankenman

Daniel B. Myers

Just as the U.S. economy has changed throughout the 21st century, so, too, has the commercial real estate market. High tech and other office tenants are using less space per employee in favor of more flexible space. Instead of 250 square feet or more per employee, some high-tech tenants are using 150 square feet or less. Non-traditional tenants, such as medical offices, dialysis centers, pet clinics and educational facilities, now occupy space in traditional retail shopping centers. These are examples of the trends that will have significant business and legal impacts on commercial real estate in the years to come.

That said, developers, landlords and tenants should consider the following:

- **Building Configurations and Values:**

As the need for space changes, tenants will seek out buildings with more flexible floor plans that can be configured into more productive spaces. These buildings will in turn command higher rents. Overall, however, without other economic drivers, if the trend for less space per employee continues, the reduction in demand for traditional office space will likely have a negative impact on building values. The expected continued increase in employees working remotely will also decrease demand for office space.

- **Common Area Charges and Services:**

Tenants with more employees per square foot will require higher levels of building services than traditional tenants. For example, higher density tenants will have greater electrical, water and HVAC demands, require increased janitorial services and produce larger amounts of garbage. Landlords need to ensure that these tenants do not overburden building services. In addition, landlords should include language in their leases to require that these high-density tenants pay their full and fair share for the increased building services. At the same time, more traditional tenants should try to protect themselves from "subsidizing" the extra consumption by the higher density tenants — as they would, for example, if the allocation of costs for services is solely calculated on a square footage basis. As a result, when entering into new leases, traditional tenants should include language, where possible, that requires landlords to install separate meters or submeters for utilities, and to allocate the cost of building services based on actual usage (as opposed to being based purely on the number of square feet occupied by each tenant).

- **Parking:**

In both retail and office settings, higher density users will have greater parking demands. Prior to entering into leases with high-density users, landlords will need to confirm that current parking areas have sufficient capacity to meet the greater needs of these tenants. For other tenants, if parking rights are important, they should negotiate specific terms to protect their parking rights, such as designating protected parking areas, specifying minimum numbers of available spaces and/or requiring landlords to implement parking management programs.

- **Compatibility of Uses:**

Particularly in the shopping center context, existing retail tenants may not want certain non-traditional tenants to occupy shopping center spaces. When negotiating leases, traditional retail tenants will want to anticipate and specify the types of prohibited uses. While many retail tenants already prohibit various immoral or obnoxious uses, tenants now may want to add other uses to these lists to try to anticipate evolving trends. Landlords, on the other hand, will need to be careful about agreeing to such limitations to preserve flexibility as space requirements and users evolve over time. This is particularly true as a number of traditional retailers, including certain big box tenants, have closed or reduced the size of stores in recent years due to increased competition from online retailers.

- **Zoning, Use and Code Compliance:**

Landlords who find new uses for underutilized or vacant spaces may need new approvals from cities, regulatory agencies and other local jurisdictions. Higher-density users may also trigger additional parking requirements, as well as fire and building code upgrades. Prior to entering into new leases, both landlords and tenants should carefully evaluate and conduct proper due diligence on all code compliance issues, and then allocate responsibility for any required upgrades.

The changing space needs for tenants in office buildings and shopping centers present both opportunities and challenges for landlords and tenants. Landlords and tenants who are able to anticipate these evolving trends and address concerns and liabilities in lease documents will be better prepared to handle these changes as they arise.

> The changing space needs for tenants in office buildings and shopping centers present both opportunities and challenges for landlords and tenants.
>
> *— Daniel B. Myers and C. Gregg Ankenman*

Daniel B. Myers and C. Gregg Ankenman, Partners, the Real Estate Practice Group at Wendel, Rosen, Black & Dean LLP in Oakland, Calif.

WARNING: ESTIMATES IN LETTERS OF INTENT CAN COME BACK TO BITE

By Manuel Fishman, Esq.

Manuel Fishman

A recent California appellate court decision has highlighted the fact that letters of intent—and landlord generated items delivered pursuant to a letter of intent — have legal consequences, even when the matters are clearly stated to be "estimates" or "nonbinding." The case stems from a lease transaction at a shopping center in Glendale, Calif., called The Americana at Brand. The tenant was Thrifty Payless [Thrifty Payless, Inc. v. The Americana at Brand, LLC, 218 Cal. App. 4th 1230 (2013)].

As with most lease transactions, this one began with a letter of intent prepared by the landlord's agent. The letter of intent provided "estimated" real property taxes, insurance and common area expenses for the first year of the lease term. The letter of intent clearly identified the dollar amounts for these charges as estimates. Thrifty requested a budget and, in response, the landlord's vice president for leasing provided Thrifty with a budget and wrote "[p]lease remember that the costs reflected are purely estimated values."

A lease was entered into and when the first bill for common area maintenance charges was generated by the landlord, the charges were billed at rates twice or three times higher than the estimated amounts. The difference, for the first year of the lease term alone, amounted to more than $300,000. The lease contained an "integration" clause that made the lease the final and binding agreement of the parties, and provided that Thrifty was entering into the lease without reliance on any statement or representation of the landlord. Nevertheless, Thrifty sued the landlord for fraud, rescission, breach of contract and breach of the implied covenant of good faith and fair dealing.

The case centered on two key legal issues:

(a) Could Thrifty rely on the estimates in the letter of intent despite

the statement in the lease that the lease was the final and binding agreement of the parties?

(b) Does a landlord breach the implied covenant of good faith and fair dealing by improperly exercising its discretion in allocating common area expenses between retail and non-retail portions of a shopping center?

Unfortunately, while the landlord was able to get a dismissal of the case at the trial level, the court of appeal reversed the trial court and allowed Thrifty to proceed on all causes of action, answering the two legal issues in favor of Thrifty. The case makes it clear that estimates in letters of intent can be a basis for a fraud claim despite language in a letter of intent that amounts stated are merely estimates and are not binding, and despite the attempt to limit the lease to the four corners of the contract.

While the Court struggled with the legal principle that adhering to the "four corners" of a lease as the exclusive expression of the intent of the parties protects the integrity of written contracts, the Court was persuaded that no contract language should absolve a party from fraud as a matter of law. The Court found that it is always a fact question, to be resolved at trial, as to whether a plaintiff reasonably relied on statements of fact — even if couched as an opinion.

The Court also found that the landlord breached the implied covenant of good faith and fair dealing, which prevents a party to a contract from engaging in conduct that frustrates the other party's rights and benefits under the contract. In the Thrifty lease, the landlord agreed to allocate common area expenses between the retail and non-retail portions of the shopping center based on "its reasonable discretion" using "sound accounting and management principles." Those words were enough for the Court to uphold Thrifty's allegation that the landlord had improperly allocated expenses in violation of the implied covenant.

The key take away from the case is that a party to a contract can present evidence, such as estimates and other written statements of fact from outside of the contract, to show that the contract was obtained by fraud. In other words, statements in a letter of intent to the effect that square footage figures or budgeted operating expenses are "estimates" cannot protect a landlord from a claim of fraud if the two key elements of fraud are satisfied: "negligent or intentional misrepresentation" and "justifiable reliance." While it may not be easy to prove "justifiable reliance," that is a question of fact that gets decided when a case goes to trial — months, and, in some cases years, after the case has been filed and significant money spent on legal fees.

Manuel Fishman, Esq., Shareholder, the Real Estate Practice Group at Buchalter Nemer in San Francisco

> Estimates in letters of intent can be a basis for a fraud claim.
>
> — *Manuel Fishman, Esq.*