

### Letters of Intent to Lease: Valuable for Landlords and Tenants

By Jay A. Gitle

Landlords and tenants occasionally ask whether they should both negotiate and execute a letter of intent to lease. Many wonder whether it might be more efficient to launch right into negotiating the lease itself. The investment in negotiating a letter of intent to lease will almost always pay quick dividends for landlords and tenants. The dividends may be in the form of an early discovery of a lack of agreement on an important issue that will allow the parties either to resolve it quickly or decide to terminate further negotiations and part ways. The more details sorted out during the letter of intent phase, the greater the likelihood of a smoother and successful consummation of the lease. Finding the proper balance of detail to include at the letter of intent phase is often a function of the nature and size of the transaction and the sophistication and leverage of the parties involved. This article is intended to help landlords and tenants consider what they may want to include in their letters of intent to lease.

**Parties.** Who are the landlord and tenant? The answer is not always obvious. The tenant will want to make sure that the landlord includes the fee simple owner of the underlying real estate to be leased by the tenant and, if the landlord is a land trust (which is common in some jurisdictions, such as Illinois), the tenant may consider requiring that the beneficiaries of the landlord's land trust join as the landlord. Similarly, the landlord will want to identify who the tenant is and secure financial information from it in order to determine what type of security deposit may be warranted and whether any lease guaranties will be necessary

and from whom. The landlord should also secure financial information from any such prospective guarantors.

**Leased Premises.** The premises should be carefully defined in the letter of intent. How many square feet? Is the square footage "rentable" or "usable?" How are rentable and usable areas calculated (what measuring standard is applied)? In an office leasing context, it is common to include the address, floor and/or suite number(s) that apply to the premises. It is also a good idea to attach an exhibit to the letter of intent depicting the premises to be leased. Are any storage areas included? Are there any special parking rights?

**Use.** How broadly will the tenant's permitted use be described? In an office property context, is the description "general office use and uses incidental thereto" adequate? Descriptions of permitted uses often have implications on the tenant's rights to assign the lease or sublease the premises. Exclusive use rights are frequently critical in retail lease transactions. Will the tenant be subject to any other party's exclusive use rights? Will the tenant enjoy the benefit of any exclusives over other tenants at the subject property?

**Lease Term and Commencement Date.** The initial term is usually described as a set number of months or years and the commencement date is not always effective on a pre-established date. Frequently, the lease commencement date is a predetermined number of days after the premises are delivered to the tenant by the landlord (including enough time to build out the space). Will the landlord allow the tenant to occupy the premises prior to the commencement date? If so, the landlord should specify in the letter of

intent that if the tenant takes occupancy of the premises prior to the commencement date (for instance, to perform improvements to the premises), all terms and conditions of the lease become effective on the date the tenant so occupies (and the tenant will want to carve out an obligation to pay base rent, real estate taxes, and operating expenses).

**Possession of the Premises.** By when and in what condition (eg, demolished and in "base building condition") will the landlord provide possession of the premises to the tenant? What are the tenant's rights if possession of the space is delayed beyond the specified date? As with most negotiated issues, depending on the parties' respective bargaining positions, the tenant may seek some form of rent abatement for each day possession is delayed beyond the specified date. What happens if there's a prolonged delay in possession not caused by the tenant? At some point, the tenant will want the right to cancel the lease.

**Base Rent, Escalations and Abatements.** Specify the initial base rental rate (usually expressed in terms of dollars per rentable square foot per year). Escalations in base rent are typically expressed in terms of an annual (or other specified period) percentage increase or a fixed dollar amount increase per rentable square foot per year. Abatements are usually described by the amount of the abatement and the number of months (eg, 100% of base rental during the first 3 months of the term).

**Operating Expenses and Real Estate Taxes.** Assuming the lease is not a gross lease, is tenant to be responsible for all operating expenses and real estate taxes or only above a

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base year or base amount? It's not unusual to attach to the letter of intent a list of exclusions from the definitions of "operating expenses" and "taxes" (or their equivalents). Will the operating expenses or real estate taxes be "grossed up" for any years that the project is not fully leased? Additionally, any projected caps on operating expense increases should be specified. Also, a brief description of the tenant's rights to audit the landlord's operating books may be helpful. Further, any limitations on management fees that can be passed through by the landlord to the tenant should be identified.

**Security Deposit.** If required, how much will the amount of the security deposit be? Is it subject to reductions at any point during the term? Will the deposit be in the form of cash or letter of credit? If cash, will the tenant be entitled to interest thereon?

**Options to Extend.** Specify the terms and conditions upon which the tenant may extend the lease term (*eg*, the number of options and years). Is the right to extend personal to the tenant? How much advance notice will the tenant have to provide to the landlord and, if the rent is not preset, how will the rent be determined? Attaching an exhibit to the letter of intent describing the methodology for determining rent during the extension term(s) is usually welcomed by both parties.

**Rights of Refusal.** Will the landlord grant to the tenant a right of first refusal to lease any other space at the project? The right of first refusal space should be specified in the same manner as the leased premises. How will the right be triggered (*eg*, by the landlord receiving a counterproposal from a bona fide third party) and what will the rental rate, concessions and lease term be for such additional space?

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Frequently, the rental rate, concessions and lease term will be the same as those that the landlord fully negotiates with a third-party tenant. Will the landlord agree that any leases to tenants on the right of first refusal space contain a relocation provision and/or limit the maximum length of lease term (including prohibiting options to renew or extend)? What happens if the tenant does not elect to exercise the right of refusal? Usually, the landlord will then receive a fixed period (*eg*, 6 months) to complete a lease (upon substantially similar terms) after which the tenant shall once again have the right of first refusal. Is the right of refusal personal to the tenant?

Will the landlord grant the tenant a right of first refusal to purchase the project? Such rights are seldom granted and usually only found in a lease of the entire project to one tenant. If granted, the tenants will certainly want to record a memorandum of their rights with the appropriate local governmental authority to provide notice to third parties (the same analysis would apply in the context where the tenant receives an outright option to purchase).

**Options to Terminate.** Will the landlord grant the tenant an option to terminate the entire lease, or any portion of the leased premises? If so, is it a continuing right or at one or more pre-established intervals? How much advance notice will the landlord want from the tenant of the tenant's intent to terminate the lease or the portion of the leased premises? How much, if anything, will the tenant have to pay to the landlord for the privilege of early termination? Many times, a tenant will pay the landlord the present value of the unamortized costs incurred by the landlord (using a discount rate), including the value of the rent abatement received, tenant improvements and brokerage commissions, which amount usually can be calculated prior to lease execution. The termination fee is often due 50% at the time of notice and the balance at the effective date of termination. As with other lease-related options, will the option to terminate be personal to the tenant?

**Options to Expand.** The parties should specify whether the landlord

grants the tenant any options to expand the premises. Carefully defining the expansion premises is a good idea and delineating when the tenant may exercise the expansion options is essential. How much notice must the tenant provide to the landlord? Will the lease of the expansion space be coterminous with the primary space and at what rental rate and concession package (*eg*, the tenant improvement allowance)? Is the expansion option personal to the tenant?

**Construction and Improvements.** Constructing and improving space requires significant planning. Allocating responsibilities is an important early step. Usually, the landlord is responsible for completing construction to a "base building" condition. Attaching an exhibit to the letter of intent specifying the base building condition is an effective method to sort out any issues. Assuming the tenant will build out its premises, the tenant will want the right to select its contractor (which will routinely be subject to the landlord's reasonable approval). The tenant may want to clarify whether the landlord may receive a fee for profit, overhead, general conditions or supervision. Will the landlord have the right to charge for the review of plans or any inspections with regard to the initial improvements? What is the submission/review/approval process and timing concerning construction/mechanical drawings? What kind of access will the tenant and its contractors have to the premises and construction site? Will the tenant have any rights to staging or stockpiling areas? Who is responsible for power and other utility costs during the buildout phase? Will construction periods be subject to extension for force majeure?

**Improvement Allowance.** Improvement allowance amounts are typically expressed in dollars per rentable square foot. Will the allowance be applied only for the cost of construction of tenant improvements, or will the tenant be allowed to apply it to costs incurred for data and telecommunication cabling, architectural and engineering fees, consultant fees, outside legal fees, moving

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expenses, equipment, trade fixtures, furniture and/or signage? What happens to any unused portions of the allowance (will the tenant be allowed a credit against rents first becoming due under the lease)?

**Alterations.** Particularly in a long-term lease, alteration rights can be important. In the context of alterations during the term, issues similar to those faced during the initial buildout come into play. The tenant may want to limit the landlord's right to object only to those proposed alterations, if any, which structurally or mechanically interfere with the integrity of the building. Typically, the tenant will want the right to perform non-structural alterations (within a modest budgeted amount — such as painting and carpeting) without having to obtain the landlord's consent. Also, the tenant will want to limit any supervisory fees imposed by the landlord in connection with the tenant's alterations. The tenant will want the landlord to notify the tenant at the time of consent if such alterations will need to be removed at the expiration of the lease.

**Default.** How many days for the tenant to cure a monetary default? How about nonmonetary defaults? Will time periods be extended if the default is not susceptible to cure within the specified time period? What happens in the context of a default by the landlord? Will the tenant have self-help and/or rights to offset rent?

**Assignment and Subletting.** The tenants will want the right, at any time, to sublease all or any portion of the premises or assign the lease to related entities (such as an affiliate, parent, or subsidiary) as well as any unrelated entities. What rights will the landlord have with respect to consent to assignments and subleases? Commonly, landlords will agree not to unreasonably withhold their consent. Will the landlord have the right to recapture the premises and, if so, under what circumstances? Tenants will want their landlords to provide notice of consent (or non-consent) or their intent to recapture within a brief interval after the tenant provides notice of the assignment or sublease.

How will the landlord and tenant split profits, if any, from the sublease or assignment? The tenant will want to make certain that before the profits are calculated, the tenant first recovers its costs to make the sublease or assignment including free rent, tenant improvements, marketing costs, brokerage fees and legal fees.

**Heating, Ventilation and Air Conditioning (“HVAC”); Building Services.** Who is responsible for providing and maintaining HVAC? During what hours will HVAC be provided? What are the after hours charges for HVAC? Usually, the standard HVAC specifications will be an attachment to the lease. If there are any unique building services to be associated with the lease transaction (eg, security services), adding them to the letter of intent is useful.

**Signage.** Signage rights can be an extremely valuable nonmonetary benefit for tenants that can occasionally distinguish one site from another. The letter of intent phase is when the scope of signage rights to be granted by the landlord to the tenant should be delineated.

**Holdover.** How much will the tenant be charged by the landlord if the tenant retains possession of its premises at the expiration or other early termination of its lease? The holdover amount is routinely expressed as a multiple (eg, 150%) of the amount of rent paid during the month prior to the holdover. The tenant will want to prevent automatic renewals of the lease for any period of time and limit the landlord's rights to consequential damages.

**Subordination and Non-Disturbance.** As a condition to the tenant's obligations under the lease, the tenant will want the landlord to provide the tenant with non-disturbance agreements in form and substance reasonably satisfactory to the tenant from all holders of superior positions (eg, prior mortgage lenders and ground lessors) to the tenant's interest under the lease. Additionally, the tenant will want the landlord to agree to provide, from time to time, appropriate estoppel, recognition and non-disturbance agreements to any assignee of the lease or subtenant of the premises.

**Contingencies.** Are either party's obligations under the lease to be contingent on the occurrence of some event? For instance, are the landlord's obligations contingent upon the approval of the landlord's lender or another tenant at the property? Are the tenant's obligations contingent upon the successful termination of the tenant's existing lease? Are either party's obligations contingent upon board of directors' approval? If any of the contingencies are not fulfilled within the time(s) specified, the lease should include language unwinding the transaction.

**Confidentiality.** The landlord, tenant and the brokers might want to agree that the terms of the transaction reflected in the letter of intent will remain confidential and any publicity regarding the transaction will not be released without the landlord's and tenant's consent.

**Brokerage.** Specifying the identities of the broker(s), what its commission is and how, when and by whom it will be paid is good practice. Usually, brokers will enter into separate written agreements concerning commissions with landlords.

**Non-Binding.** At the letter of intent stage, the parties do not want the terms and conditions set forth in the letter of intent to be binding upon them until such time as a lease and related documents have been approved, executed and delivered by both parties. A disclaimer may include language confirming that the letter of intent is solely an outline to assist the parties in attempting to work toward a complete lease. Sometimes, the parties want a partially binding letter of intent as to certain obligations (such as to negotiate solely with each other for a limited interval).

### CONCLUSION

If the landlord and tenant are successful in completing a comprehensive letter of intent, they will have laid a proper foundation for enhancing the likelihood of achieving a smoother and more predictable lease documentation and negotiation phase.

