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EXCLUSIVE

Best Surprise Is No Surprise

By Edward Goodman | Commentary

All potential buyers are well served by an awareness of the many important clauses that may be included in a lease and their broader implications to the value of a deal, says Goodman.

NEW YORK CITY-Potential buyers in corporate acquisitions go to great lengths to understand the real value of a company prior to acquiring it. They conduct in-depth and sophisticated due diligence, and their attorneys and accountants thoroughly investigate a target company's legal obligations and financial status to gain a clear understanding of its assets and liabilities.

Among the documents typically reviewed are leases, subleases, licenses and/or other occupancy agreements that relate to the locations in which a target company conducts business. And while the rent and other economic provisions of these agreements are typically reviewed in the course of deciding whether a company is a wise investment, it is important to pay attention to other clauses in a lease that can compromise the value of an acquisition.

1. Expansion, Termination and Renewal Rights available only to the Initial Tenant

Landlords occasionally limit expansion rights, termination rights and renewal rights to initial tenants, prohibiting an *assignee* of the initial tenant to exercise such rights. This restriction will not necessarily be included in the section of the lease granting these rights, where it might be expected. It may instead be in the miscellaneous section of the lease, or somewhere less prominent, and expressed in a simple sentence such as: "All option rights granted to Tenant under this lease are personal to the tenant named herein and may be exercised only by such tenant."

If such a restriction is not favorable to a buyer's future plans, the buyer should seek to have this limitation deleted with respect to the assignee. If it is not recognized and addressed in advance, it may threaten the success of the acquisition.

2. **Abandonment or Vacancy**

Buyers of companies may plan to consolidate operations and move the target company's employees to its own offices. In so doing, the buyer will want to sublet the target company's premises or further assign the target's lease to offset the continuing rent obligations. With this in mind, a buyer will naturally review the lease's assignment and subletting provisions to ensure flexibility in subleasing or assigning after the acquisition.

A less-considered risk is the possibility that upon the relocation of the target company's employees and equipment from its premises, the landlord will be entitled to *terminate* the lease due to a lease provision that allows termination without notice, or any opportunity to cure, if the tenant "abandons" or "vacates" the premises. Because procuring a subtenant or assignee following an acquisition often takes time, the premises are often temporarily "vacant" or in a condition that the landlord may argue amounts to "abandonment." This could leave the acquirer vulnerable if a landlord is then entitled to collect damages under the applicable lease or to re-let the premises at a higher rent and realize potential profits that might otherwise be realized by the acquirer.

With proper planning, it may be possible to minimize the risk of the lease's being terminated because of vacancy or abandonment by keeping some furniture, equipment and/or employees in the space even after the completion of the relocation. It is always important for a potential buyer to carefully review and understand the lease provision in question and the laws of the jurisdiction in which the premises are located.

3. **Restoration of Premises at End of Term**

Commercial leases commonly contain provisions that require the tenant, at the landlord's option, to restore the leased premises to their condition at the start date of the lease -- essentially, to leave the space as they found it. Depending on installations and updates that have occurred over time, this "restoration" may be expensive. As part of an analysis of the acquisition and future costs, a buyer should be fully aware of any obligations and costs related to this provision.

4. **Allocation of Purchase Price**

It is common for landlords to require a tenant to share some or all the profits that the tenant earns by subletting or assigning its lease. In a typical lease assignment, the amount paid by the assignee for the lease assignment is deemed to be the "profit" that is to be shared with or taken by the landlord. However, when a lease is assigned as part of a larger acquisition, the situation becomes more complicated.

Where a lease contains a profit-sharing provision, before consenting to a lease assignment, the landlord will likely require the tenant to advise (or even certify to) the amount of the consideration being paid for the lease assignment. The last thing an acquirer or acquiree wants to face is a demand by a landlord to review the asset purchase agreement, related documents or financial information to facilitate the landlord's analysis of the "profit" being realized by the tenant from the lease assignment.

One way to avoid the need to disclose potentially confidential agreements and information relating to the acquisition may be to include a provision in the asset purchase agreement (if applicable in the subject transaction) to the effect that no portion of the purchase price for the company is allocated to the lease assignment(s). By including this provision the tenant can truthfully advise or certify to the landlord that, per the acquisition document, no consideration is being paid to the assignor for the lease assignment. Ideally,this provision will resolve this issue to the satisfaction of all parties.

5. Relocation of Tenant

Landlords often retain the right to relocate tenants to alternative locations in a building, to accommodate the needs of an important existing or potential tenant. This right of a landlord can result in loss of productivity, potential loss of business, and a less optimal location for tenants relocated as part of an accommodation. A potential buyer should be made aware of any risk of this nature before proceeding with an acquisition.

6. **Competitors**

In some businesses, arrangements where a tenant leases space in a building that contains the offices of a competitor – or where a competitor has obtained naming rights – can be uncomfortable or unacceptable. In these instances, it is important that the lease restrict the landlord's right to lease space in the building to, or name the building after, certain specified companies or companies engaged in certain businesses.

If this is a requirement for a buyer and the lease to be assigned contains such a provision, then there is no problem. However, if this provision is *not* included in the lease, then a buyer needs to be aware of the ***absence*** of such a provision so that it may be raised with the landlord prior to effectuating the lease assignment.

While the relevance of the provisions identified in this article will certainly depend on the size and type of acquisition, all potential buyers are well served by an awareness of the many important clauses that may be included in a lease and their broader implications to the value of a deal. The monetary obligations spelled out in a lease are only part of the story, and no acquisition should be made without understanding the complete picture.

Edward Goodman is a member of the Real Estate Group at the New York City law firm of Ingram Yuzek Gainen Carroll & Bertolotti LLP, where his practice includes the representation of clients in local, national and international commercial leasing transactions, as well as other types of real estate transactions. He also advises clients on the real estate issues in corporate mergers and acquisitions. The views expressed in this column are the author's own.