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QUESTIONS TO ASK BEFORE YOU SIGN A LEASE

GUIDE

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To make sure your business needs are met, be aware of a wide range of considerations when negotiating a commercial lease.

HOW LONG WILL THE LEASE RUN?

Typically, commercial leases run anywhere from three to 10 years, and the term is usually negotiable with the landlord. It is just as important to pin down when the lease will begin as it is to determine when it will end. Unless the space you agree to occupy is already vacant and remodeled to fit your needs, all kinds of last-minute problems can occur. For example, an old tenant refuses to move out; construction isn't finished on schedule; disagreements arise about whether you can gain early access to install fixtures and make your own improvements.

Your lease should clearly illustrate what will happen if the space is not ready by the move-in date and what adjustments in rent will be made by the landlord. Be wary of clauses that allow the landlord to provide "alternative" space if the new premises are not ready on time. This deal may only increase your cost and inconvenience of moving. If you have any doubts about whether your new space will be ready on time, give yourself some leeway in moving out of your old premises. Otherwise you may find yourself operating out of a moving van while lawyers squabble over the fine print.

Please Note: If you are seeking financing, your bank may be hesitant to provide a business loan with repayment terms that will outlast the lease term.

HOW MUCH IS THE RENT?

Rent, unlike other business expenses, is a fairly inflexible part of your overhead and may be deceiving. Commercial rents are generally measured by the annual cost per square foot of the space but there are at least five common ways to calculate rent, every one of which uses square footage as the basis for comparisons:

- > **Gross leases** – Once the most common standard for office space, gross leases, simply required the tenant to pay a flat monthly amount; the landlord is responsible for all the expenses of operating the building, including taxes, insurance and repairs. Because of rising energy costs, many landlords now charge tenants separately for heat and electricity which used to be included in the gross rent.
- > **Net leases** – This type of lease requires tenants to pay for some or all of the real estate taxes on a property in addition to base rent.
- > **Net-net leases** – These leases go one step further than the net lease. Besides base rent and taxes, the tenant pays for insurance on the space they occupy.
- > **Net-net-net or "triple net" leases** – Usually written only for industrial properties, triple net leases effectively pass on all the costs of operating the building, including repairs and maintenance to the renter.
- > **Percentage leases** – These leases are a special type of rental arrangement that applies to retailers, especially in multiple-tenant malls or shopping centres. In a percentage lease, the tenant pays a fixed rate plus a percentage of gross income.

HOW MUCH WILL THE RENT GO UP?

Not very long ago, the increasing costs of operating a building, could be caught up by increasing the rent every time a new tenant moved in or when a lease was renewed. Now, however, the costs of operating real estate are so unpredictable, most landlords feel they need protection in the form of escalation clauses.

One common type of escalation clause builds in regular step-ups in rent over the course of the lease; others pass on prorated increases in taxes, heat, maintenance and other direct costs. Another common escalation clause automatically raises rents according to the Consumer Price Index (CPI) or some comparable index of inflation. Since the CPI generally overstates the impact of inflation, a tenant should not agree to pay more than a portion of the annual CPI increase, especially if the lease already contains escalators for taxes and direct operating costs.

Most landlords will negotiate the key elements in the escalation clause, including the base year. If you move in halfway through the local fiscal tax year, for example, your base year for taxes could be any of three years - the previous tax year, the present year, or even the next full year. The same holds true for heating costs and other elements of the owner's overhead. In particular, you should be careful about the base year if you move into a new building that may take a year or two to reach full capacity, since the owner won't have a stable history of operating costs to use as a reasonable base.

CAN YOU SUB-LEASE?

Two years into a five-year lease, you discover your company is bursting at the seams and it is time to find a new home. What happens next may depend on a rather delicate negotiation with your landlord over what kind of sub-leasing he considers "reasonable".

At the very least, you will have to come up with a new tenant who meets the same standards that the owner applies to other tenants. You are not off the hook if you find a massage parlour willing to take over your space in a prestigious shopping mall, or a punk-rock band that plans to use your office space for practice sessions. Moreover, if your subtenant decides to skip town, you are still responsible for paying the rent on the original lease.

Now, though, there is a new wrinkle to the traditional negotiations over subleasing privileges: the question of who keeps the profits if your new tenant pays more than you did for rent. In today's tight rental market, that situation occurs fairly often, and landlords are naturally eager to write leases that given them more control over sub-leasing arrangements. One tenant who merged his company with another business recently found an eviction notice in his mail. The landlord claimed that the "new" corporation had no valid lease for the premises, and would have to pay a higher rent to stay on.

CAN YOU RENEW?

Once your present lease expires, a landlord has no legal obligation to offer the same (or other) space to you. Unless you have agreed on a renewal formula and have a clause that guarantees you will get first rights to the space when your lease expires, you will no doubt pay the prevailing market rate to continue.

Normally, a tenant has to give written notice exercising his option to renew his lease, or it lapses automatically (a year's notice for long-term leases, while only three or four months might be standard for short-term leases.) Some leases, however, are renewed automatically until you take steps to cancel them. This can be a handy arrangement for companies with several branch locations, that don't want to risk having their leases run out by accident.

WHAT HAPPENS IF YOUR LANDLORD GOES BROKE?

A few years ago, a doctor moved into a small, privately owned medical building and spent a fortune on renovations and built-in equipment. One morning a bank officer showed up and announced the doctor's 10 year lease was void, because the bank had foreclosed on the building. The doctor could stay at twice his original rent or move within 30 days.

The doctor could have protected himself either by making sure his lease contained a standard "recognition" or non-disturbance clause. If a landlord balks on this point, it may be that he is on shaky financial ground.

WHO'S RESPONSIBLE FOR INSURANCE?

In the rush to firm up a lease, insurance rarely gets the attention it deserves. The result is that many buildings—especially those with multiple tenants—are covered by a hodgepodge of overlapping and inadequate coverage. This is not only costly, it also invites disaster. In case of fire or other major disaster to the building, it may take years before the various insurance companies sort out the claim and decide what is and is not covered.

Landlords in general are expected to carry a comprehensive policy on the building that covers liability for common areas, such as lobbies, stairways and elevators, and provides casualty protection for the building itself. They also have the right to insist that tenants carry their own insurance to protect the landlord against claims that might arise from the conduct of their businesses (a visitor who trips on an office carpet, for example) and "contents and improvements" coverage that protects his investment in the property itself.

Making sure the policies dovetail, though, is really a job for a professional insurance agent or a lawyer with expertise in insurance. He/she should be able to review the building owner's policies, help close any dangerous gaps, and spot unnecessary expenses.

WHAT BUILDING SERVICE DO YOU GET?

Just about the only way a landlord squeezed by inflation can cut his costs is by lowering thermostats and reducing maintenance. It is a good idea, therefore, to define in writing precisely what services you are entitled to get as part of your lease. Some points:

- > Electricity is often supplied as part of the building services, however a landlord may set limits if you plan to install electrical machinery or extra air conditioning.
- > Heating, ventilation, and air conditioning (HVAC) are also usually the landlord's responsibility. Unlike apartment buildings, though, commercial space rarely offers 24-hour HVAC service. You should attach an HVAC schedule to the lease itself, and even specify what service is to be provided on statutory holidays. (Normal HVAC service is usually available Monday through Friday, from 8 a.m. to 5 p.m. and Saturday from 8 a.m. to 1 p.m.)
- > Cleaning services can make a big difference in the appearance your company presents to the public, so you should request a specific cleaning schedule and who is responsible for housekeeping details such as cleaning restrooms and taking out the trash.

WHO ELSE CAN MOVE IN?

How would you feel if a close competitor moved in next door? Or a business that generated strange odours or loud noises? Or one that attracted unsavoury people? To some degree, zoning laws protect businesses from "incompatible" uses, such as retail businesses in office buildings, or manufacturing in a retail neighbourhood. But, you can also negotiate stricter limits with your landlord if you feel it is necessary.

Just remember, if you must sub-lease, those strict requirements may give your landlord reason to reject your selected tenant.

WHO PAYS FOR IMPROVEMENTS?

Modern office buildings generally provide allowances for improvements—new partitioning, lighting, carpets, paint, etc.—but there may be variations in individual tenant needs, and what landlords are willing to provide. No other area of a lease, in fact, is so open to negotiation and hard bargaining between landlord and tenant.

This bargaining is complicated by the high costs of even minor construction jobs. A single new electrical outlet, for example, may end up running \$20/metre to lay down; carpets, plasterers, and painters may bill their time from \$15 to \$30 an hour. If the building owner is carrying the remodelled space rent-free during construction, the cost may be substantial.

You are more likely to persuade a landlord to pay the bill for major renovations if the changes you request will suit future tenants as well. Unusual partitioning, carpets and wallpaper with strange patterns or colours won't add to the value of the landlord's property. They may even have to be removed before the space is marketable again.

Agreements about renovations should be put in writing, preferably with a detailed floor plan and estimate of costs from a contractor, before the lease is signed. This document, called a "workletter", should also specify who owns any improvements. Unless you agree otherwise, anything a tenant attaches to the space he occupies—air conditioners, light fixtures, shelving, cabinets, even his own office and manufacturing equipment—will eventually become the landlord's property. An example of this was a person who learned this lesson the hard way. He had just installed a handsome new reception desk, and was dismayed to learn he would have to leave it behind once he moved. The worst part of this situation is that he paid for improvements the new tenants received free.

HOW MUCH SPACE ARE YOU REALLY RENTING?

Commercial rents are almost always priced by the square metre, that is, the amount of annual rent a tenant pays for each square metre of the space occupied. Raw warehouse or factory space might rent for only a few dollars per square metre; first-class office space or a desirable storefront might rent for \$30 to \$40 a square metre.

Square meterage is a handy yardstick for comparing rents. But not all landlords measure square meterage in the same way, so you need to ask two key questions: How much usable space will you get for your money? and How much of your rent is apportioned to "public" space such as lobbies, hallways, bathrooms, and mechanical areas (25% and 30% are typical)?

There are several standard formulas real estate professionals use to measure and apportion space, particularly for modern high-rise office buildings. The "New York Multiple Tenancy Floor Method" for example, divides the cost of lobbies and bathrooms among the tenants on each floor, but excludes elevator shafts and stairways. The "BOMAS International Method", on the other hand, allocates all the costs of common areas on multiple-tenant floors to the building as a whole, while the "Boston Method" charges tenants for the lobbies and hallways on each floor but not the bathrooms, elevator shafts and mechanical rooms. Take note if you only rent a portion of a floor, as differences can add up to large variations in rent over the lifetime of your lease. It pays to know exactly what you are getting.

**For more information, please contact the World Trade Centre Winnipeg:
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