

KEEPING THE REINS ON “FREE” RENT

By Steven P. Heller, Esq.

A landlord who uses care in giving a new tenant “free rent” will avoid giving away the store and may retain certain benefits as compared with granting other types of concessions.

“Free” rent is never really free. A rent credit does not allow a tenant to get around paying rent entirely; instead, it is merely a mechanism for creatively structuring the payment of rent in a lease transaction.

Typically, the tenant pays no rent for the first months of the term, and the face rental rate increases for the rest of the term, so the tenant gives up the lower face rental rate for the entire term.

For example, consider a 10-year lease with an effective annual rental rate of \$24 per square foot. Instead of insisting on a face rental rate of \$24 per square foot for the entire 10 years, the landlord agrees to grant the tenant two years of free rent and to increase the face rental rate to \$30 per square foot for the remaining eight years.

Tenants like free rent because it offsets other cash outlays they may have to make at the beginning of the lease term, such as moving expenses, the cost of new furniture and equipment or the last months of rent payments for the overlapping term of a previous lease. A tenant naturally appreciates having lower rent costs while starting up or relocating.

The landlord, too, should recognize the relative utility of the rent credit. The landlord leases space in a weak market to a tenant that may be shopping space in multiple buildings. The effective rental rate over the entire term does not change, and the face rental rate for the lease transaction increases.

This higher “pro forma” rent attracts buyers, facilitates refinancing and strengthens the landlord’s position when the next potential tenant comes along.

The drawback for the landlord is obvious: The rent money comes in later than it would otherwise.

In addition, free rent undercuts the tenant’s financial and symbolic investment in the space. It deprives the landlord of immediate revenue to show for the occupied space. Free rent concerns the landlord’s lender and investors. And it forces the landlord to prolong the time at which the tenant shows itself capable of meeting its routine rent payments.

Further, the landlord may have tax liability for effective rent deemed earned during free-rent periods when the landlord receives no actual revenue.

Unhappy as the landlord may be after resigning itself to making these concessions, it cannot afford to make the mistake of giving away even more by ignoring the more subtle elements of the terms of the free-rent lease provisions.

A landlord that wants to retain some control over unbridled free rent should consider doing the following:

Push Back Free-Rent Periods

The entire free-rent period need not occur at the beginning of the lease term. Apply some of the rent credit to base rent due at the end of lease term, or spread it out in alternating months or at other strategic points throughout the term, so that the landlord can collect

sooner at least some revenue for the leased space.

The landlord reduces its risk by recovering its costs for the initial delivery of the space and having some cash to show for the lease if the tenant quickly defaults or goes bankrupt.

Meanwhile, the tenant invests in the space from the beginning of the term and proves itself capable of making routine rent payments at the face rate.

Consider Most Favorable Mix of Concessions

Rent credits are not the only way to induce tenants to lease space.

Alternative types or combinations of tenant incentives can involve parking fees, operating expenses and taxes, percentage rent, storage space, tenant moving costs, overtime services, freight elevator charges, construction fees for alterations, fees for amenities such as health club memberships and day care and, of course, tenant improvement allowances.

While each of these raises concerns, the landlord should pursue the mix of concessions most advantageous for its circumstances and priorities.

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Limit and Clearly Specify What Is Free

Resist the tenant's request to expand the free rent to operating expenses and taxes or other charges that represent actual occupancy costs caused by tenant's use of the space, unless the landlord determines that such a credit is in its interest.

Spell out the charges to which the credit does and does not apply.

Condition Credit on Tenant Not Defaulting

Free rent is not a free ride. The landlord gives it away in return for the tenant's performance of the other terms of the lease.

Characterize "free rent" as a rent credit paid by the landlord to the tenant. Provide that the landlord does not need to pay the tenant the rent credit if the tenant has not paid all of the rent it owes under the lease, is bankrupt or is otherwise in default.

Clarify Rates for Renewal and Holdover Terms

If the lease ties the rental rate for these additional periods to the rental rate for the initial term, then the landlord should make sure that the lease refers to rent payable during the last month of the initial term or clarify that the basis for the calculation is the face rate, not the lower effective rate.

Account for Overlapping Abatement Periods

Rent abatement during a free-rent month that results from casualty, condemnation or interrupted utilities should not result in a free-rent windfall for the tenant.

For example, if the lease grants the tenant a rent credit for the full \$10,000 monthly base rent during a month when a casualty results in a rent reduction to \$6,000, then the tenant's rent credit for the month correspondingly is reduced to \$6,000.

The landlord should specify that free rent during an abatement period decreases proportionately to any abatement. But bear in mind that the tenant may resist losing its rent credit because of a casualty or other event that it did not cause.

Tenants in a weak market use every economic advantage they can to obtain concessions, especially with the painful memory of a booming landlord's market only a few short years ago.

While landlords may need to offer inducements such as rent credits to fill their buildings with the best of a small group of potential tenants, they need to impose sensible restrictions on "free" rent.

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