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Leasing Essentials

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THE LEASE CONTRACT

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A lease is both *an instrument of conveyance* and *a contract* between principal parties to uphold certain covenants and obligations. As a conveyance, a lease conveys an interest, called the leasehold estate, but does not convey legal title to the property. For this reason, a leasehold is also called a **less-than-freehold** estate.

The four principal types of leasehold estate are:

- ▶ **estate for years:** has a specific lease term
- ▶ **estate from period-to-period:** the lease term automatically renews
- ▶ **estate at will:** has no specified lease term
- ▶ **estate at sufferance:** a tenancy without consent

The legal essence of a valid lease is that *it conveys an exclusive right to use and occupy a property for a limited period of time in exchange for rent and the return of the property after the lease term is over*. Leasehold estates are distinguished from freeholds by their temporary nature. Every leasehold has a limited duration, whether the term is 99 years or not stated at all, as in an estate at will. While the lease conveys exclusive use, it may also *restrict such use* to conform to the landlord's desires. For example, an apartment lease may prohibit a tenant from using or storing hazardous materials within the premises.

Like other contracts, a lease becomes a binding agreement when the parties accept the terms of the agreement and communicate their agreement to the other party. Recording of a leasehold conveyance is not a requirement for validity, although it is usually good procedure to do so.

In a lease arrangement, the owner is the **landlord**, or **lessor**, and the renter is the **tenant**, or **lessee**.

Leasehold rights and obligations

Tenant's rights and obligations. A lease conveys a **leasehold interest** or **estate** that grants the tenant the following rights during the lease term:

- ▶ exclusive possession and occupancy
- ▶ exclusive use
- ▶ quiet enjoyment
- ▶ profits from use

A tenant has the sole right to occupy and use the premises without interference from outside parties, including the landlord. The landlord may enter the premises for specified purposes such as inspections, but the interference must be reasonable and limited. In addition, the landlord can do nothing outside of the lease's express provisions that would impair the tenant's enjoyment of income deriving from use of the premises. For example, the landlord can not place a kiosk in front of a retail tenant's entry in such a way as to prevent customers from entering the store.

The lease defines the tenant's obligations, which principally are to:

- ▶ pay the rent on time
- ▶ maintain the property's condition
- ▶ comply with the rules and regulations of the building

Landlord's rights and obligations. In conveying the leasehold estate, the landlord acquires a **leased fee estate**, which entails the rights to:

- ▶ receive rent
- ▶ re-possess the property following the lease term
- ▶ monitor the tenant's obligations to maintain the premises

The lease defines the landlord's obligations, which principally are to:

- ▶ provide the necessary building support and services
- ▶ maintain the condition of the property

Death of tenant or landlord. A valid lease creates obligations that survive the death of the landlord or tenant, with certain exceptions. A tenant's estate *remains liable for payment of rent if the tenant dies*; the landlord's estate *remains bound to provide occupancy despite the landlord's death*.

Conveyance of leased property. The landlord may sell, assign, or mortgage the leased fee interest. However, transferring and encumbering the leased property do not extinguish the obligations and covenants of a lease. Buyers and creditors, therefore, must take their respective interests subject to the terms of the lease.

Contract requirements

State contract laws determine the requirements for a valid lease. These laws generally require the following conditions.

Parties. The principal parties must be legally able to enter into the agreement; i.e., meet certain age, sanity, and other requirements.

Property description. The lease must identify the property by legal description or other locally accepted reference.

Exclusive possession. The landlord must provide an irrevocable right to exclusive possession during the lease term, provided the tenant meets all obligations.

Legal and permitted use. The intended use of the property must be legal. A use that is legal but not permitted does not invalidate the lease but constitutes grounds for default.

Consideration. The lease contract must be accompanied by consideration to the landlord for the rights conveyed. How the consideration is paid does not affect the lease's validity, so long as the parties comply with the terms of the lease.

Offer and acceptance. The parties must accept the lease, and communicate their acceptance to the other party, for the lease to take legal effect.

Signatures. The landlord must sign the lease to convey the leasehold interest. A tenant need not sign the lease, although it is prudent to do so in order to enforce the terms of the lease. Multiple tenants who sign a single lease are jointly and severally responsible for fulfilling lease obligations. Thus, if one renter abandons an apartment, the other renters remain liable for rent.

Oral versus written form. Generally, *a lease for a period exceeding one year cannot be oral but must be in writing to be enforceable* because of the Statute of Frauds. An oral lease or rental agreement is legally construed to be a tenancy at will, having no specified term. Further, an oral lease terminates on the death of either principal party.

Lease clauses

The clauses of a lease define the contractual relationship between landlord and tenant. The most important and basic clauses are the following.

Rent and security deposit. A rent clause stipulates the time, place, manner and amount of rent payment. It defines any grace period that is allowed, and states the penalties for delinquency.

The lease may also call for a security deposit to protect the landlord against losses from property damage or the tenant's default. State law regulates the handling of the security deposit: where it is deposited, and whether the tenant receives interest on the deposit. A landlord may require additional financial security from a tenant of dubious creditworthiness in the form of personal guarantees, third party guarantees, or pledges of other property as collateral.

Lease term. In the absence of an explicit term with beginning and ending date, a court will generally construe the lease to be a tenancy at will, cancelable upon proper notice.

Repairs and maintenance. Repairs and maintenance provisions define the landlord's and tenant's respective responsibilities for property repairs and maintenance. Generally, the tenant is responsible for routine maintenance of the premises while the landlord is responsible for general repairs. In residential leases, the landlord is responsible for major repairs and capital improvements. Payment of repairs and maintenance costs, however, is entirely negotiable between landlord and tenant.

Subletting and assignment. Subletting (subleasing) is the transfer by a tenant, the **sublessor**, of a *portion* of the leasehold interest to another party, the **sublessee**, through the execution of a **sublease**. The sublease spells out all of the rights and obligations of the sublessor and sublessee, including the payment of rent to the sublessor. The sublessor remains *primarily liable* for the original lease with the landlord. The subtenant is *liable* only to the sublessor.

For example, a sublessor subleases a portion of the occupied premises for a portion of the remaining term. The sublessee pays sublease rent to the sublessor, who in turn pays lease rent to the landlord.

An assignment of the lease is a transfer of the *entire leasehold interest* by a tenant, the **assignor**, to a third party, the **assignee**. There is no second lease, and the assignor retains no residual rights of occupancy or other leasehold rights unless expressly stated in the assignment agreement. The assignee becomes primarily liable for the lease and rent, and the assignor, the original tenant, remains secondarily liable. The assignee pays rent directly to the landlord.

All leases clarify the rights and restrictions of the tenant regarding subleasing and assigning the leasehold interest. Generally, the landlord cannot prohibit either act, but the tenant must obtain the landlord's written approval. The reason for this requirement is that the landlord has a financial stake in the creditworthiness of any prospective tenant.

Rules and regulations. A tenant must abide by all usage restrictions imposed by the lease's rules and regulations for the property. These rules aim to protect the property's condition as well as the rights of other tenants.

Improvements and alterations. A landlord typically wants to prevent a tenant from making alterations that later tenants may not desire. By the same token, a tenant who pays for an improvement wants to know who will own it at the end of the lease term. An improvements and alterations clause therefore identifies necessary permissions and procedures, and who owns improvements. Customarily, tenant improvements become the property of the landlord in the absence of an express agreement to the contrary.

Options. An option clause offers a tenant the opportunity to choose a course of action at some time in the future under certain terms. Typical options are the right to renew the lease, buy the property, and lease additional adjacent space. A tenant does not have to exercise an option, but the landlord must comply if the tenant does exercise it.

Damage and destruction. A damage and destruction provision defines the rights and obligations of the parties in the event the leased premises are damaged or destroyed. State laws regulate such provisions.

TYPES OF LEASE

Gross lease
Net lease
Percentage lease
Residential lease
Commercial lease
Ground lease
Proprietary lease
Leasing of rights

Gross lease

A gross lease, or **full service** lease, requires the landlord to pay the property's operating expenses, including utilities, repairs, and maintenance, while the tenant pays only rent. Rent levels under a gross lease are higher than under a net lease, since the landlord recoups expense outlays in the form of added rent.

Gross leases are common for office and industrial properties. Residential leases are usually gross leases with the exception that the tenants often pay utilities expenses.

Net lease

A net lease requires a tenant to pay for utilities, internal repairs, and a proportionate share of taxes, insurance, and operating expenses in addition to rent. In effect, the landlord "passes through" actual property expenses to the tenant rather than charging a higher rent level. Net leases vary as to exactly what expenses the tenant is responsible for. The extreme form of net lease requires tenants to cover all expenses, including major repairs and property taxes.

Net leases are common for office and industrial properties. They are sometimes also used for single family dwellings.

In practice, the terms net and gross lease can be misleading: some gross leases still require tenants to pay some expenses such as utilities and repairs. Similarly, some net leases require the landlord to pay certain expenses. Prudent tenants and landlords look at all expense obligations in relation to the level of rent to be charged.

Percentage lease

A percentage lease allows the landlord to share in the income generated from the use of the property. A tenant pays **percentage rent**, or an amount of rent equal to a percentage of the tenant's periodic gross sales. The percentage rent may be:

- ▶ a fixed percent of gross revenue without a minimum rent
- ▶ a fixed minimum rent plus an additional percent of gross sales
- ▶ a percentage rent or minimum rent, whichever is greater

Percentage leases are used only for retail properties.

Residential lease

A residential lease may be a net lease or a gross lease. Usually, it is a form of gross lease in which the landlord pays all property expenses except the tenant's utilities and water. Since residential leases tend to be short in term, tenants cannot be expected to pay for major repairs and improvements. The

landlord, rather, absorbs these expenses and recoups the outlays through higher rent.

Residential leases differ from commercial and other types of lease in that:

- ▶ lease terms are shorter, typically one or two years
- ▶ lease clauses are fairly standard from one property to the next, in order to reflect compliance with local landlord-tenant relations laws
- ▶ lease clauses are generally not negotiable, particularly in larger apartment complexes where owners want uniform leases for all residents

Commercial lease

A commercial lease may be a net, gross, or percentage lease, if the tenant is a retail business. As a rule, a commercial lease is a significant and complex business proposition. It may involve hundreds of thousands of dollars for improving the property to the tenant's specifications. Since the lease terms are often long, total rent liabilities for the tenant can easily be millions of dollars.

Some important features of commercial leases are:

- ▶ long term, ranging up to 25 years
- ▶ require tenant improvements to meet particular usage needs
- ▶ virtually all lease clauses are negotiable due to the financial magnitude of the transaction
- ▶ default can have serious financial consequences; therefore, lease clauses must express all points of agreement and be very precise

Ground lease

A ground lease, or **land lease**, concerns the land portion of a real property. The owner grants the tenant a leasehold interest in the land only, in exchange for rent.

Ground leases are primarily used in three circumstances:

- ▶ an owner wishes to lease raw land to an agricultural or mining interest
- ▶ unimproved property is to be developed and either the owner wants to retain ownership of the land, or the developer or future users of the property do not want to own the land
- ▶ the owner of an improved property wishes to sell an interest in the improvements while retaining ownership of the underlying land

In the latter two instances, a ground lease offers owners, developers, and users various financing, appreciation, and tax advantages. For example, a ground lease lessor can take advantage of the increase in value of the land due to the new improvements developed on it, without incurring the risks of developing and owning the improvements. Land leases executed for the purpose of development or to segregate ownership of land from ownership of improvements are inherently long term leases, often ranging from thirty to fifty years.

Proprietary lease

A proprietary lease conveys a leasehold interest to an owner of a cooperative. The proprietary lease does not stipulate rent, as the rent is equal to the owner's share of the periodic expenses of the entire cooperative. The term of the lease is

likewise unspecified, as it coincides with the ownership period of the cooperative tenant: when an interest is sold, the proprietary lease for the seller's unit is assigned to the new buyer.

Leasing of rights

The practice of leasing property rights other than the rights to exclusive occupancy and possession occurs most commonly in the leasing of water rights, air rights, and mineral rights.

For example, an owner of land that has deposits of coal might lease the mineral rights to a mining company, giving the mining company the limited right to extract the coal. The rights lease may be very specific, stating how much of a mineral or other resource may be extracted, how the rights may be exercised, for what period of time, and on what portions of the property. The lessee's rights do not include common leasehold interests such as occupancy, exclusion, quiet enjoyment, or possession of the leased premises.

Another example of a rights lease is where a railroad wants to erect a bridge over a thoroughfare owned by a municipality. The railroad must obtain an air rights agreement of some kind, whether it be an easement, a purchase, or a lease, before it can construct the bridge.

DEFAULT AND TERMINATION

Remedies for default

Default by tenant

Default by landlord

Causes for lease termination

Remedies for default A landlord or tenant who violates any of the terms and covenants of the lease has breached the contract and is in default. In the event of a default, the damaged party may pursue court action, including suing for

- ▶ damages
- ▶ cancellation of the lease
- ▶ specific performance

A successful suit for **specific performance** compels the defaulting party to perform the contract obligation that was breached. For example, if a landlord fails to replace carpeting as promised in the lease, the tenant can sue to obtain the landlord's specific performance of installing a new carpet.

Default by tenant

Tenant default occurs most commonly from failure to pay rent or maintain the premises. If a tenant is in default, the landlord may file a **suit for possession**, also called a **suit for eviction**. If successful in this suit, the landlord can repossess the property and evict the tenant. The landlord also has the right to sue for damages.

Before filing a suit for possession, the landlord must give the tenant proper notice to pay monies due or otherwise cure the default before a deadline, or else vacate the premises. If the deadline passes without satisfaction, the landlord may

file the suit and obtain a judgment for possession. The landlord may then obtain an order directing the sheriff to complete the eviction, forcibly if necessary.

Default by landlord

The most common form of landlord default is failure to provide services and maintain the property condition. When a landlord defaults on the terms of the lease, tenants may sue for damages. In an instance where the landlord's negligence or disruptive action has rendered the property unoccupiable, a tenant may vacate the premises and declare that the lease is cancelled by default. This action, called **constructive eviction**, can nullify the tenant's lease obligations if the claim succeeds in court. In order to obtain a constructive eviction judgment, the tenant *must vacate* the premises.

For example, a landlord will not repair a roof and will not allow an office tenant to make the repair and deduct the cost from the rent. A thunderstorm soaks the suite and ruins several pieces of office equipment. By refusing to act, the landlord has breached the lease covenant to maintain the premises. The tenant moves out, claiming the lease null and void. The tenant also sues the landlord for damages to the equipment and for recovery of relocation expenses.

Causes for lease termination

A lease may terminate for any of the following causes.

Breach or default. Breach of contract or default, as previously discussed, may terminate a lease.

Term expiration. In a tenancy for years, the lease automatically terminates at the end of the lease term.

Notice. Proper notice by either party may terminate a periodic leasehold, or a tenancy at will.

Voluntary agreement. Both parties can agree to terminate a lease at any time.

Property destruction. Destruction of the property is grounds for terminating lease obligations.

Condemnation. A taking by eminent domain proceedings generally terminates a lease.

Foreclosure. A foreclosure extinguishes all prior interests in a property, including a leasehold.

Death of tenant or landlord, with qualifications. A lease for tenancy at will terminates on the death of either landlord or tenant. A lease also terminates on the death of the landlord if the landlord held a life estate interest in the property, since the landlord could not have conveyed an interest that extended beyond his or her own interest.

Except in the circumstances mentioned, a lease *does not* terminate on the death of the landlord or tenant. Sale of the property also does not terminate a lease.

Abandonment. If a tenant abandons a leased property and demonstrates no intention of fulfilling the obligations of the lease, the landlord may re-take possession and pursue legal recourses for default. In such a case, the tenant remains liable for payment of rent. The landlord also has the option of terminating the lease, which releases the tenant from responsibility for rent.

However, the landlord may be able to sue for damages and at the same time re-let the property.

It is important to note that vacating leased premises does not in itself constitute abandonment, and certainly not if the tenant continues to abide by the lease obligations.

UNIFORM RESIDENTIAL LANDLORD AND TENANT ACT (URLTA)

Areas of regulation

The **Uniform Residential Landlord and Tenant Act (URLTA)** is a model law enacted as a blueprint for state laws to *regulate leasing and management practices of landlords with residential properties*. Numerous states have enacted tenant-landlord regulations in response to the law.

The act aims to:

- ▶ equalize and standardize rights of landlord and tenant
- ▶ protect tenants from unethical practices
- ▶ prevent unfair, complex leases and their enforceability

One important effect of URLTA is that it prompted legislation at the state level that empowered the courts to nullify residential leases that violated URLTA guidelines, particularly where a lease gave unfair advantage to the landlord.

Areas of regulation

URLTA legislation primarily addresses the lease contract, deposits and advances, obligations of landlord and tenant, the landlord's rights of access, and standards for eviction.

Lease agreements. URLTA sets standards for improving oral, vague, or unbalanced lease agreements. The law's positions on these issues are:

- ▶ unclear lease term: becomes a periodic tenancy
- ▶ rent amount: fair market value or court's opinion
- ▶ waiving of rights: certain rights cannot be waived

The law intends to avoid irregularities and vagueness in the lease term and rent obligations, as these can cause exaggeration in a landlord's claim for the amount of rent due from a defaulting tenant. A vague lease term can also lead to a dispute about the duration of a tenant's possession rights. A landlord, for example, could claim that a lease has expired in order to acquire a higher-paying tenant. URLTA also discourages the landlord practice of persuading tenants to waive rights they do not understand or are unaware of.

Deposit and advance. URLTA requires leases to be clear about:

- ▶ maximum deposit amount
- ▶ the tenant's right to earn interest on the deposit

- ▶ commingling deposit or advance with other monies
- ▶ deadline for returning deposits
- ▶ procedures and criteria for return of the deposit to the tenant

Although URLTA applies to how landlords can handle deposits and advances, state laws also strictly regulate how brokers and agents may handle tenant monies.

Landlord's obligations. Under URLTA, a landlord must:

- ▶ bargain in good faith with the tenant
- ▶ provide required maintenance
- ▶ make repairs
- ▶ comply with local building codes
- ▶ provide access and safety services: elevator; fire escapes, etc.
- ▶ provide a procedure for delivery of official notices

Tenant's obligations. A tenant must:

- ▶ bargain in good faith
- ▶ maintain the condition of the leased premises
- ▶ abide by (legitimate) rules and regulations of the building
- ▶ refrain from abusing or causing destruction to the property
- ▶ limit uses to those approved
- ▶ avoid unduly disturbing other tenants

Access. URLTA attempts to balance the landlord's right to access the premises with the tenant's right of quiet enjoyment. The landlord has the right to enter the premises at any time when acting to prevent damage or destruction; to make repairs or show the property, on giving proper notice; if the purpose is not arbitrary and the time is reasonable. The tenant may not refuse the landlord entry for acceptable reasons such as emergencies, repairs, inspections, and showings.

Default and eviction. URLTA attempts to establish equitable procedures for dealing with lease defaults. If the landlord defaults, a tenant may sue for damages, terminate the agreement, or negotiate a rent abatement. Tenants generally are not released of liability for rent during a dispute. Rents, however, may be paid to a court impound pending judgment. If a tenant defaults, the landlord may terminate and evict, provided proper notice is made and the landlord can justify the cause for the action.

Exemptions. State laws based on URLTA generally do not apply to transient occupancies, such as hotel and motel rentals, proprietary leases in cooperatives, or to occupancy in a residence that is under a contract for deed.

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Leasing Essentials Snapshot Review

THE LEASE CONTRACT	• instrument of leasehold conveyance; contract of covenants and obligations
Leasehold rights and obligations	• landlord grants temporary, exclusive use in trade for rent and reversion • tenant rights: exclusive use and possession; quiet enjoyment; profits • tenant obligations: pay rent; maintain premises; follow rules • landlord rights: receive rent; repossess; monitor property condition • landlord obligations: support and services; maintenance • leasehold rights survive death and conveyance or encumbrance
Contract requirements	• parties; legal description; exclusive possession; legal use; lease term; consideration; offer and acceptance; signatures; written if over one year in term
Lease clauses	• rent; deposit; term; repairs and maintenance; subletting and assignment; rules and regulations; improvements; alterations; options; damage; destruction
TYPES OF LEASE	• based on expense responsibility; how rent is paid; property type; rights leased
Gross lease	• landlord pays expenses; tenant pays more rent
Net lease	• tenant pays some or all expenses; rent is less
Percentage lease	• landlord receives rent minimum plus percentage of retailer's sales
Residential lease	• gross lease hybrid; short term; uniform terms reflect landlord-tenant standards
Commercial lease	• longer term; entails tenant improvements; complex, negotiable lease terms
Ground lease	• landlord owns and leases ground but does not own improvements
Proprietary lease	• for cooperative unit owners; indefinite term; assigned to new unit owner on sale
Leasing of rights	• leasehold transfer of rights for limited use; examples: air, mineral, water rights
DEFAULT AND TERMINATION	
Remedies for default	• sue for damages, lease cancellation, and/or specific performance
Default by tenant	• cancellation; damages; suit for possession; must give proper notice
Default by landlord	• suit for constructive eviction; must vacate premises to uphold
Causes for lease termination	• default; term expiration; notice; voluntary agreement; property destruction; condemnation; death, in some cases; abandonment
UNIFORM RESIDENTIAL LANDLORD AND TENANT ACT	• aims to balance landlord and tenant rights; to standardize leases and eviction procedures; to protect tenants; serve as model for state-level legislation
Areas of regulation	• contract language; waiver of rights; deposit; obligations of landlord and tenant; default and eviction