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LETTERS OF INTENT, USE AND STRATEGY

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INTRODUCTION

What is a letter of intent? As a general rule a letter of intent is a written expression which sets forth the intention of the parties specified to enter into a formal more definitive agreement (contract/lease) or to take or refrain from some specified action as stated. It is thought of in general terms as an agreement to enter into a more definitive agreement. As with most things of a legalistic nature it can be quite confusing, since a letter of intent is not necessarily a letter but can be accomplished in any writing that meets the criteria. Most letters of intent are filled with conditions concurrent, subsequent and precedent. These letters are used in all types of business transactions, for large and small transactions alike and are not exclusively a vehicle used for real estate transactions. Letters of intent are a very common

vehicle in real estate leasing transactions. The scope of this article is specifically limited to providing some assistance on the sum and substance of a letter of intent in a commercial real estate office lease. Since numerous articles have been written about what makes a letter of intent binding or non-binding we have intentionally not addressed that issue. Instead we have assumed that you have retained competent legal counsel to assist you at the letter of intent stage and the letter is either binding or not binding per your desired result. The second assumption that we have made is that the lease is of some substance to the Tenant in duration or magnitude. The third assumption is that the market is good for both Landlords and Tenants. That is neither party is in a must do this deal situation. The fourth assumption is

that we are negotiating for space that is currently in place and this is not space that needs to be developed.

Why a Letter of Intent, Why not go directly to a Lease?

The basic answer to the above question is that letters of intent are used as cost savings devices. Letters of intent as a general rule cost less to develop and negotiate than a formal lease. The expenditure of funds by both parties will increase after a letter of intent has been mutually executed or upon the commencement of lease preparation. On the Landlord's side of the ledger you have the following costs:

- Space Planning – often the initial fit plans are paid for by the Landlord;
- Attorneys' fees – although the Landlord's initial preparation of the lease is historically less costly to the Landlord than to the Tenant such documents could be expensive if prepared by external counsel.

On the Tenant's side of the ledger is attorneys' fees. Tenants historically pay more money than a Landlord in the review and comment to a lease. This is true for one very basic reason. The Landlord's lease is just that, the Landlord's lease. The attorney that prepared the Landlord's lease was hired by the Landlord paid for by the Landlord to represent the Landlord interests. Even the most fair of Landlord oriented attorneys directed by their clients to create an even-handed lease that any sophisticated Tenant will sign with little to no comment just cannot help but prepare a lease that favors the Landlord. Even with the best of drafting and intent their interest are just not the same. When all is said and done even the most even-handed fair minded Landlord prepared lease will favor the Landlord to the detriment of the Tenant.

Although space planning can be sometimes accomplished on an economical basis attorneys' fees are the trigger for a substantial investment of both time and money. The smaller the transaction the higher the cost on a prorata share. Why is this so? Leases are not substantially any simpler or shorter for smaller use Tenants. You still have all the same issues but on smaller transaction the Tenant's ability to obtain change is diminished.

Prior to the expenditure of any significant dollars both the Landlord and Tenant desire to ensure that they are not wasting their money. Letters of intent serve the purpose of indentifying whether or not a

deal actually exists. If you can get past the letter of intent stage it is likely that a lease can be agreed to.

What happens to Leverage?

First of all, we thought it might be useful to have a short general discussion about leverage. In the business world leverage comes to mind in two capacities. First, as the use of credit to enhance one's speculative capacity. Secondly, as an advantage, force, or influence. Our focus here is on the second definition of leverage. We find it simple to think of leverage as "advantage" or "momentum". Personally we feel "momentum" is a more accurate synonym. As a general rule, both parties gain some leverage once they enter into a letter of intent. Notwithstanding that the letter of intent may be non-binding both parties desire to consummate the deal. The Landlord will also lose some leverage since in most circumstances he will cease marketing the space to other viable Tenants. At the same time, the Tenant will lose some leverage since in most circumstances the Tenant will stop considering other viable properties. It is our summation that prior to the entering into a letter of intent the leverage is on the Tenant's side. If time permits the Tenant can always abandon this building and move on to another. However, once the letter of intent is signed the Tenant will commence the investment of funds and time into this project. Secondly, during the initial space planning process the Tenant's organization will become involved in the process. What does this mean to the Tenant? Simply that as more and more of his organization become involved, Tenant's organization will be buying into this project. Walking away from this transaction becomes more difficult as more of Tenant's organization invests their time and energies. From the Landlord's perspective the more involved the Tenant's organization, the better.

In all negotiations leverage is not easy to obtain and once obtained even more difficult to retain. Leverage can be lost by a mere inadvertent communication and once it is lost, leverage is not easily regained. Leverage like all precious commodities is not static. In this sense leverage is most like momentum. One thing for sure leverage will move back and forth by and between the parties during the course of lease negotiations.

The Long and the Short of it

The next issue that we should address is whether or not we desire a comprehensive letter of intent or a bare bones bullet point type letter of intent? Here are some of the considerations:

- The first consideration is cost. The larger the transaction the more detailed the letter of intent. Will more time spent on the letter of intent increase attorneys' fees? I do not believe that we can provide a scientific answer but our supposition is that the more time upfront actually limits the back-end lease preparation on a very cost-effective basis. On the other hand, I can assure you that an ill prepared, incomplete letter of intent will greatly increase the back-end lease preparation costs. Prevention is generally much more cost effective than repair. Our recommendation is if you are going to go through the trouble of preparing a letter of intent by all means spend the time to do it correctly.
- If market conditions generally favor your side, you may want a more detailed letter of intent vs. the bare bones variety. The reason for this is simple, although the letter of intent may not be binding most lawyers and businessmen are very ethical and do not enjoy changing terms, covenants or conditions specifically set forth in a letter of intent.
- Landlords tend to favor bare bones. Astute Landlord counsel will often state that we have to address all those issues in the lease, let's get on with the deal and let's not duplicate effort! Although this argument appears to make sense it is not entirely accurate. It is an accurate statement in that you will have to deal with all the issues in the lease. Secondly, some of the tediously detailed requirements of some legal issues are best left to the lease. It is important to set forth all of the "substantive deal concepts" in the letter of intent. What are substantive deal concepts? Simply critical business and legal issues that have a material effect on the objective of the transaction. Substantive deal concepts from a business perspective are easily identifiable, rent, improvement allowance, operating expenses and any other provision that generally has a direct readily identifiable cost attached to it. Substantive deal concepts from a legal perspective are not so easily identifiable but can be of equal significance from a financial risk perspective. For example, hazardous waste, types of insurance Tenant will maintain, Tenant's

exit strategy issues, early termination, assignment and subleasing and transferable rights to name a few. For instance, if the Tenant or Landlord's Lender requires a Nondisturbance, Subordination and Attornment Agreement it is not necessary to set forth the terms, covenants and conditions of the Nondisturbance, Subordination and Attornment Agreement in the letter of intent but it is important to memorialize the concept. Further, if we have to address the issue anyway isn't it better to determine whether or not the issue is a deal breaker prior to proceeding to lease documents? Additionally, if a concept is properly addressed in the letter of intent it is unlikely that such issue will become a deal breaker or unduly prolong the lease finalization process. Why do Landlord's tend to like them short and sweet? The reason is simple, the Landlord's standard lease already addresses all the substantive deal concepts in a fashion that he is very comfortable with. Secondly, once the Landlord and Tenant sign the letter of intent, barring other extenuating circumstances, the leverage commences its movement toward the Landlord's side of the equation. Since, the Landlord's lease will favor the Landlord, the Tenant is now in the defensive or investigative phase and has a threefold challenge: (a) first he must find and understand the offending provision of the lease (not always as easy as it would appear); (b) once found he must convince the Landlord to modify the concept; and (c) come to an agreement as to the exact language, which will accurately memorialize the agreed upon concept.

- Tenants tend to favor detailed and longer letters of intent. The larger the transaction the more detail in the letter of intent. This is especially true amongst the more sophisticated Tenants. If it isn't in the letter of intent it will simply be more difficult and time consuming to exact the desired substantive deal concept from the Landlord. As the old saying goes; we wish we had a nickel for every time a Landlord counsel or representative said, "it isn't in the letter of intent....."

Some Landlord oriented lawyers have quipped that "we simply do not need a 150 page letter of intent for a 10 page lease". Some Tenant oriented lawyers have counter-quipped "you are right if all that is desired is the right for the Tenant to pay rent under any and all circumstances". Both ends of this debate can be extreme.

Our thoughts on the subject are simple. A well-crafted letter of intent first should be reflective of the order of magnitude of the deal. The more dollars at stake the more detail in the letter of intent. Personally we have seen 3 page letters of intent that had too much detail and 15 page letters of intent that did not have enough.

Here are some things that we believe should be specifically addressed in any letter of intent. Our philosophy has been dictated by the legendary real estate guru Slicing Sam Sandbagger, "Leases are like golfers, some lease provisions are more equal than others".

We personally consider these eight provisions to be the crux of any conceptual lease transaction: (i) the Parties; (ii) Description of Premises, Building, Common Areas, how and when the Premises will be

measured; (iii) Lease Term and Rent Commencement Date; (iv) Rent, Escalations, Operating Expenses, Inclusions and Exclusions; (v) Assignment and Subleasing, including the other important rights in the Lease (signs, options etc.); (vi) Improvements, Improvement Allowances, other allowances and what is counted against the allowances; (vii) Parking; and (viii) Options (Additional Space and Extension of the Lease Term). The concept is simple: Within these eight provisions you will generally describe who is involved, what you are getting, when you are getting it, for how long you are getting it, what can you do with it and how much you have to pay for it. A more thorough checklist is attached for your perusal and use.

In closing, letters of intent have been with us for a long time and will continue to be a useful tool if applied properly to the transaction at hand.

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CHECKLIST FOR A LETTER OF INTENT

- A. Identification of the parties.
- B. Contact and notice information.
- C. A general description of the building, common areas, parking and the project, tenant's share of the building. Exhibits work well here.
- D. The premises its size, measurement standards and when will it be measured and by whom, floor load factor? If the Premises is to be delivered at different dates, specific detail as to the delivery and Rent Commencement.
- E. Parking location and type, whether reserved, unreserved, single, tandem, garaged, covered or uncovered. Number of spaces must take versus optional and methodology for give backs. Does landlord own and control parking or independent owner and the parking charges (if any).
- F. Rent commencement date, how determined? If the rent commencement date is tied to the construction of improvements what happens if the date of substantial completion of the premises are delayed by a landlord caused delay, a tenant delay, a force majeure delay? Rent and escalations and abatements; exclusions from operating expenses, and tenant's audit rights.
- G. If free rent for a substantial period how secured (letter of credit, memorandum of lease, nondisturbance, subordination and attornment agreement, etc).
- H. If tenant is to have a substantial cost in tenant improvements how secured (letter of credit, memorandum of lease, nondisturbance, subordination and attornment agreement, etc).
- I. Purity of the tenant improvement allowance. What will the allowance be use for. What Landlord charges are to be allowed against the improvement allowance? What is the base building condition or core and shell specifications?
- J. The amount of the tenant improvement allowance, how calculated, when paid (process and timing) and the construction responsibilities, including responsibility for overages, the amount (if any) of the landlord's overhead and profit, and the pricing of labor and materials to be furnished by the landlord. Who bears responsibility if base building not to specifications, representations and warranties, contains hazardous waste, contains toxic mold, sick building syndrome, etc.
- K. Tenant self-help rights and tenant's cancellation options, especially during the "dead zone" (foreclosure proceedings) and in emergencies.
- L. Expansion "must take" space, if any, including timing, cost, and relevant space; ROFO or first refusal space; if any.
- M. Extension options, number, duration, rent and when must exercise?
- N. For extensions and ROFO's mechanism for determining rent. If fair market rental rate how determined and timing;
- O. Type of lease, NNN, FSG or MSG. If FSG with base year, expense stop what included in base year, etc. How will a high energy user be treated, separately metered?
- P. Representations and warranties by landlord's warranties regarding: Hazardous materials; Asbestos; Compliance with laws; including ADA of 1990, environmental laws; Sick building syndrome; Toxic mold; Building condition; Building systems; Litigation; Security; and Parking.
- Q. Permitted use (tenants, assignees and subtenants).
- R. Assignment and sublease rights, exclusions from consent requirements, what rights are transferable, recognition agreements.
- S. Signage on the building, exclusivity, assignability, maintenance, cleaning, monument full floors, and directory.
- T. Nondisturbance, subordination and attornment agreement, memorandum of lease, recordation.
- U. Exclusive types of use for tenant and restrictions as to competitors or undesirable co-tenants for the tenant. Within the project and radius restrictions if controlled by the landlord.
- V. Building hours and days. What services will be available during non-building hours? How will tenant access after hour HVAC and electricity? Holidays that will be recognized by the landlord.
- W. Building management, location, response etc.
- X. Security deposit, commingled, separate and when returned to Tenant.
- Y. Brokers in the lease or totally separate agreement?
- Z. Binding, non-binding? Specify the conditions concurrent, precedent and subsequent.