

Letters of Intent in Commercial Real Estate Leases

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Letters of intent (LOIs) are frequently used by parties to formalize terms for commercial real estate leases. LOIs are implemented in the beginning stages of a transaction to ensure there is a meeting of the minds on major deal issues. This article outlines steps for drafting LOIs to both protect the parties and to effectively negotiate and finalize a commercial real estate lease agreement.

The Basics

LOIs can be referred to as term sheets, memoranda of understanding, commitments or other titles, depending on the industry and business of the parties involved. Regardless of the name, an LOI is the document that sets forth the material terms and business agreement of a commercial real estate lease.

Parties and Property

An LOI should include fundamental items of a deal, including the parties and the property. An LOI must specifically state the complete legal names of the parties involved in the transaction, as well as the property address and the property type, whether warehouse, office, industrial or retail. The property description should also include any notable items such as whether the property is part of a shopping center or condominium regime, if the location is single-tenant or multitenant, or if the premises are located on a multiple parcel development.

Rental Structure, Deposits and Incentives

An LOI should clearly state the economic terms of a lease. With respect to rent, an LOI must note the base rental amount and yearly escalations, if any, as well as whether the lease is (1) a triple net (with all taxes, insurance costs and common area and operational expenses passing through and being paid by the tenant); (2) gross (with the tenant paying one monthly base rent payment and all taxes, insurance costs and common area and operational expenses built into that base rent amount); or (3) modified gross structure (being a combination of triple net and gross lease structures, with the tenant paying a monthly base rent payment and some, but not all, property expenses).

The LOI should also detail the monetary amount of any deposits, the form of the deposit (whether cash or letter of credit), and any potential reduction of the security that may be permitted by the landlord during the lease term. Further, an LOI should include any incentives, such as tenant improvement allowances and rental abatements.

Dates and Term

An LOI should include pertinent dates applicable to a lease, such as the date the premises will be delivered to the tenant, the commencement date and the rent commencement date. In addition, an LOI should identify the length of the term and any extension terms. It is best practice to also include the notice time period required to exercise an option, as well as the rental rates for an extension term in an LOI.

Elementary but Essential

Although the above noted items are rudimentary, addressing these items in the beginning stages of a transaction not only permits a party to best understand the deal but also allows attorneys to highlight and address potential issues before drafting and negotiating the lease.

For example, when representing a landlord, it is important to identify the actual tenant entity that will be party to the lease and to confirm with the landlord that the financial statements provided for the tenant match that entity name exactly. In the same light, knowing property-specific information ignites a conversation about exclusivity restrictions, operational and development regulations, and other due diligence items that may be applicable to a certain site.

Further, a client needs to understand when the premises will be delivered for its use and occupancy, as well as any potential risks arising from a delivery date that is contingent on certain work being completed at the premises. Therefore, discussing the lease commencement with a client opens discussions on issues such as the termination of an existing lease, the timing for relocating to a new location, and remedies for a landlord failing to timely deliver premises.

Client and Property-Specific Provisions

In addition to the basic elements noted above, an LOI should include all material operational and property matters that a client may require in connection with a proposed lease.

For example, parking, signage and security requirements, if any, should be negotiated and addressed in the letter. An LOI should also identify any requirements for a tenant to continuously operate throughout the term. Furthermore, if a party desires any preferential options at a site, including an early termination right, a right of first refusal or option, or any expansion or contraction option, it is imperative that these rights are expressly set forth in the LOI.

In addition, an LOI should address any property-specific matter. If tenant improvements will be completed at the premises, the LOI should specify which party is completing the improvements, as well as any allowance that will be provided. In addition, an LOI should state verbatim the permitted use of the tenant. Further, when representing a retail tenant at a multitenant location, it is best practice for an LOI to include a copy of all exclusive uses and prohibited use restrictions currently in effect at the site so the tenant can identify any issues affecting its intended use of the premises.

Nonbinding Nature and Binding Exceptions

Most parties intend for LOIs to be nonbinding and simply a blueprint to future lease negotiations. However, a court may find an LOI to be enforceable, and, therefore, it is important that parties include certain nonbinding language

in the letters. Specifically, LOIs should clearly state the letter is “nonbinding.” In addition, parties should include a statement in the LOI providing that the LOI should not be construed as a binding contract between the parties until a lease agreement is executed and delivered by both landlord and tenant.

In order to clarify the nonbinding nature of an LOI, counsel should remove any covenant for the parties to negotiate in good faith that may be included in a form LOI. Further, counsel should confirm that there is no characterization of an LOI as a final agreement in the letter.

Notwithstanding the general intent for LOIs to be nonbinding, parties may want to have certain provisions within an LOI to be binding upon execution of the letter. For example, when lease negotiations need to remain confidential, an LOI should include a confidentiality provision that is immediately binding on the parties. Also, if a tenant desires to restrict a landlord from marketing the property during lease negotiations, this “exclusivity” restriction should be binding on the parties upon execution of the LOI.

Conclusion

Despite their brevity, LOIs must be carefully drafted and negotiated and include all material terms for a proposed lease agreement so counsel can quickly proceed with legal negotiations in the most efficient manner.

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