

## **Commercial Tenants: Important Lease Terms You Need to Understand**

Entering into a commercial lease represents a long-term commitment and investment for businesses. The terms and conditions agreed to today have the potential to affect the bottom line many years down the road. It is important for commercial tenants to understand what the language in their leases means and what consequences each provision can have for the future.

### **What Rent Is Being Charged?**

Unlike residential leases, the amount of rent that commercial lessors charge often consists of a base rent that is fixed plus a "percentage rent" that is a portion of the tenants revenues or profits from conducting business on the lessors property. Typically, this is calculated as a percentage of the tenants gross receipts, gross sales or net profits.

Problems can arise when it is not clear what the percentage consists of. For example, in *Western Medical Enterprises v. Albers*, 166 Cal. App. 3d 383 (1985), the central disagreement was whether Medi-Cal payments counted towards gross sales in determining the rent for a convalescent hospital.

Additional problems may arise when the amount of rent is not a fixed number but based on an undefined concept like "fair market value." Without drafting these provisions precisely, commercial tenants can be left in a precarious state when disputes arise as the courts will often interpret the leases according to the parties intent.

### **Restrictions on Use**

Commercial leases may also contain use restrictions that can limit the use of the property by the tenant. For example, a lease may limit the use of the premises to a restaurant. In California, such restrictions are governed by statute through California Civil Code Section 1997.010 et seq. According to the statutory scheme, these restrictions apply not only to the tenant but also to subtenants and assignees. California Civil Code Section 1997.020(a), (b) and (d).

The statute allows any use restriction so long as it is not an unlawful or ambiguous restriction. If the landlord insists on a restriction in use, the tenant may try to negotiate for a consent clause, which would allow the tenant to change their use of the premises subject to prior approval by the landlord. Tenants entering into leases with these types of provisions should understand the future needs of their businesses and market for their goods or services. These provisions ensure that it will not hamper their ability to turn a profit should economic conditions change and a need for a different business model arises.

Restrictions on use can lead to litigation where the amount of rent is not a fixed amount but based on the fair market value of the premises. And the way in which the fair market value is calculated can change depending on the purpose for which the premises are used.

This was precisely the issue in *Wu v. Interstate Consolidated Industries*, 226 Cal. App. 3d 1511 (1991). In that case, the tenants who operated a movie theater sued their landlord, Interstate Consolidated Industries (ICI), for declaratory relief to determine the meaning of "fair market value" under the lease. The lease between the landlord and the tenants restricted the use of the premises to a movie theater. The tenants argued that fair market value should be determined according to the purpose under which the lease was entered into. By contrast, the landlord argued that fair market value must be determined based on the best use of the property, which would be as retail space, and would result in much higher rent for the tenants. Ultimately, the court decided that the rent should be calculated based on the purpose of the use of the premises when the parties entered into the lease not the use that would produce the greatest value. Thus, the court interpreted the lease in such a way that to some extent split the difference between the outcomes the landlord and tenants wanted.

This is just one example of how ambiguous language in a commercial lease can lead to unwanted litigation and unexpected increases in rent.

If you have any questions or comments, I would be delighted to hear from you.

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