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Lease terminology can trip up even the wary; don't rely on labels

Here is a true story for you, one which has happened before and will most certainly happen again.

"Joe Investor" recently sold a few commercial real estate assets, which he owned for a long time and received a handsome gain. Joe is now looking to take some of the profits from these recent sales and invest in a turnkey investment through a 1031 exchange (so the gains from these sales can be deferred).

Joe is at the point in his career where he does not want to actively manage multiple assets; he would really like to do little more than collect 12 rent checks a year.

Joe contacts his favorite commercial real estate broker and puts her on the task to specifically find him a "triple-net" property within the next 45 days (per the 1031 exchange time requirements) to ultimately be purchased as his replacement property for the exchange.

In Joe's mind, this type of property will perfectly accomplish his goals. He will obtain a property with potentially a safe and very creditworthy publicly traded company as a tenant, such as a McDonald's or a CVS, and he will have no landlord responsibilities during the term of the lease.

The broker diligently follows his instructions, and within a couple of weeks, they have narrowed the search to three or four potential triple-net targets.

They review the financials of each tenant, perform their own financial analysis for each asset and even visit a couple of the sites that are geographically desirable. Joe then identifies three of these targets as his potential replacement properties under his planned 1031 exchange — just prior to the expiration of the 45-day identification period.

In the weeks following, Joe signs nondisclosure agreements with the current landlords and obtains copies of the underlying leases and any other plans or reports that were not provided to him previously.

He then contacts his commercial real estate attorney and updates him on the status of the proposed transaction and asks the attorney to now review the underlying leases to confirm that they are truly triple-net so that Joe will indeed have no maintenance, repair or financial obligations during the term of the subject lease when he becomes landlord.

This is where Joe's plan starts to go awry.

Joe's attorney thoroughly reviews each lease and provides a simple abstract highlighting the financial terms of each lease as well as the maintenance and repair obligations of each party and other items Joe should be concerned with.

In short, two of the leases would be what most consider a triple-net lease as the underlying tenant is responsible for all real estate taxes, insurance and maintenance.

However, for each, the landlord was responsible for all foundation, roof and exterior wall repair and replacement (which is quite typ-

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ical in triple-net). In one of them, the landlord was also responsible for exterior landscaping and snow removal.

Upon review of the third lease, it was discovered that the tenant was responsible for taxes and insurance, but a maintenance reserve was being deducted from base rent to cover any and all structural repairs and common-area maintenance.

The landlord was also responsible for common-area assessment payments due pursuant to an underlying reciprocal easement



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agreement on title.

Upon hearing the news of the contents of these leases, Joe flips! He is distraught that he has now blown his 45-day identification period with three properties that do not achieve one of his main goals — to have zero landlord responsibilities upon purchase.

Since he specifically requested only triple-net leases from his broker, he is dumbfounded. What became quite clear very quickly was that Joe really wanted an "absolute-triple-net lease" (sometimes called a "bondable" lease or "hell-or-high-water" lease), and he did not make this distinction clear to his broker because Joe misunderstood the meaning of a triple-net lease, as do many investors.

In broad strokes, all commercial leases fall somewhere "between the absolutes." On one end of this

spectrum is the absolute net lease, as outlined above, and on the other end, the absolute gross lease (sometimes called a "fully serviced lease"), whereby the tenant pays a fixed amount of rent to the landlord and is responsible for all other expenses relating to the property.

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For example, when many investors like Joe mention a triple-net lease, they may very well be thinking about an absolute net lease. Similarly, there is little or no distinction between a "modified-gross" lease and, say, a "double-net" lease. There are no one-size-fits-all leases, and each document boils down to what was negotiated and included in the lease between the original landlord and tenant.

There are two very clear morals to Joe's story.

First, one must always read the lease thoroughly. As discussed, just because a lease has a commonly used label attached to it such as "triple-net" or "full-service" doesn't mean that the terms of that lease — and the resulting obligations to either a landlord or a tenant — fit neatly into a preconceived and labeled package.

Second, particularly in a deal where the underlying lease is a key component to the viability of the transaction (such as Joe's above), read the lease as early as possible.

Joe waited until after his 45-day identification period to thoroughly review his subject leases; assuming all the while that the label "triple-net" on each of his identified deals would ultimately meet his requirements.

By adhering to these two simple maxims, one can rather quickly assess just where in between the absolutes a subject lease falls.