

Leasing for Start-Ups (and Other Small Businesses): Five Key Points To Consider Before Signing A Lease

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After salaries and benefits, a company's lease is typically one of its largest expenses. Here are five essential points to consider before signing a lease for your business.

1. The Exit Strategy

Many companies think their lease is one-and-done. "Sign it and forget it." But what happens if your company expands rapidly? Or things don't work out quite as you had planned and your new venture needs to downsize? What if a major investor dilutes your control or you decide it's time to cash out? Will your lease accommodate these events?

Probably not - or at least not easily - even if the lease says "the tenant can assign or sublet the space if the landlord consents, and the landlord must be reasonable when it decides whether or not to consent."

Why? First, what does "reasonable" really mean - how are you going to prove that the landlord isn't acting reasonably? And more pernicious, if the landlord won't be reasonable, there's probably little you can do about it because hiding somewhere in the back of almost every lease is a provision that says that if the landlord won't be reasonable, the tenant can't sue for damages: it can only try to convince a court to force the landlord to consent - long after it doesn't matter anymore. In the worst case scenario, this means that you can't sell the business unless the landlord says you can.

Think about your exit strategy. Here is what you want your lease to let you do without the landlord's consent:

- Sell the business (by selling all of its assets)
- Sell the company (by selling enough of your stock that you no longer control it)
- Issue new stock (so an investor now controls the company)
- Go public
- Issue shares to current or future investors, officers, directors or employees, or an employee benefit plan, that leaves you with less than 50% of the equity, even if you maintain control
- Convert the company from an LLC to a corporation or other form of entity

2. Options If You Want To Expand Or Contract

What if the business needs more space or, unfortunately, less? Although a landlord will almost never agree to reduce the space or assign the lease without its reasonable consent simply to accommodate a change in a tenant's need for less space, the tenant can try to add a set of conditions that address the landlord's concerns and eliminate the most likely reasons the landlord might say no. These include (among others):

- The proposed new tenant is experienced in the business
- The proposed new tenant is as financially sound as the current business was when it signed the lease
- The proposed tenant is not a business that is already thinking about leasing space in the building (so the proposed tenant will not be competing with the landlord)

For a growing company, however, being able to remain in a current location and simply add more space is often the ideal solution. Many smaller tenants don't ask, but it is always worth trying to obtain an expansion option in the building if space becomes available.

3. If You Have to Guaranty The Lease, Make Sure It's A True Good Guy Guaranty

Most good guy guarantees aren't so good, at least not for the founder or major investor in the business who usually signs it. It used to be that a good guy guaranty created an incentive for the guarantor to be a "good guy" by paying all of the back-due rent of a floundering tenant and immediately surrendering the space back to the landlord to be quickly rented again. Today, however, many (if not most) good guy guarantees are a guarantee of almost every possible liability under the lease, with so many conditions beyond paying overdue rent and vacating the space that the guarantor's potential liability becomes incalculable and it is nearly impossible for the guarantor to be released from the guaranty. Guarantors should limit their liability, and if they can't then they should make sure they know exactly what they are signing.

But the (Not So) Good Guy Guaranty usually contains a trap that guarantors can easily not be aware of: if the lease is assigned or sublet, or even if the business is sold and the guarantor has nothing to do with the company anymore, the guarantor stays on the hook. It is critical, therefore, that in these situations, the lease permits the tenant to replace the guarantor. Of course, the proposed replacement must be financially sound and otherwise reasonably acceptable to the landlord, but if the proposed replacement guarantor protects the landlord to the same degree as the original guarantor, there is no reason the landlord shouldn't be required to allow the switch.

4. Think Hard About Location

The real estate mantra "location, location, location," is not quite as important for startups and smaller business. Still, location should not be ignored. The right location can affect a company's ability to find and retain employees. It can help create the right image for the company. But most important, a building (i.e. a landlord) that understands and appreciates the special leasing needs of startups and small businesses increases the chances of signing a more favorable lease. Which leads directly to the final key point.

5. Hire a Tenant Broker

Perhaps the most important thing a business (of any size) can do is hire a broker who is experienced with the business' particular needs. Moreover, a startup or small business should try to find a broker who represents only tenants. Tenant representatives are less interested in staying on the landlord's good side and more focused on addressing the needs of the tenant's business. This is particularly important for startups, because the right broker will:

- Know the best buildings for startups
- Have an understanding of the more flexible landlords when it comes to the special needs of start-ups
- Have an incentive to address a myriad of other issues that are especially important to start-ups

While these five points obviously aren't the only important matters in a lease, they are essential for every startup and small business to consider before signing a lease.

In my next Leasing for Start-Ups article, we'll discuss the importance of brokers in more detail.

About Andrew Baraff



Partner in Reitler's transactional real estate and real estate finance practice. He specializes in sophisticated real estate and business transactions, including "special situations" – uncommon problems that demand creative thought and innovative solutions. Andrew is also a trusted advisor to his clients, providing counsel on real estate and non-real estate issues, alike. Andrew has a results-oriented, business approach to the practice of law – he offers creative strategic thinking to find practical solutions to complex problems.