



Winter 2008 Newsletter

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This article is part one of understanding what's involved in a tenant personally guaranteeing a lease. This impacts mostly small businesses

PERSONALLY GUARANTEEING YOUR LEASE

YOU HAVE FOUND YOUR NEW BUSINESS LOCATION...

THE LANDLORD WANTS YOU TO SIGN A "PERSONAL GUARANTEE" FOR THE LEASE...WHAT DOES THIS MEAN?

After all the hard work and time you invested in finding the best location for your small business, you finally come to the point when you are ready to negotiate the business terms of the lease. You have either submitted a "Letter of Intent" (LOI) or a "Request for Proposal" (RFP).

You have submitted your business plan and financial statements to the landlord, it all seems like its heading in the right direction...or else why would the landlord have taken the time to deal with you? You finally arrive at what is an agreement of the business terms and the landlord agrees to prepare a lease for you and your attorney's review.

Upon reviewing the lease, making sure all the business terms that were mutually agreed upon have been written into the lease properly, you come to a section of the lease titled...

"Personal Guarantee of the leasehold obligation" or something titled very similarity.

Your heart skips a beat and the blood drains out of your brain. You think at first you and/or your attorney may have missed something during the negotiation of the business terms etc. You search through all your notes, emails, hard copies etc, and found nothing about this topic. How can this be you ask yourself? What is this all about? I can't possibly guarantee a lease for the entire term, and the lease guarantee language says if there is any kind of default in the fulfillment of the lease terms all current and future rents become due and owing. This can't be happening you say.

My attorney set my business up as an LLC or "C" Corp, or any other type of legal entity for the sole purpose of limiting my personal liability. This must be some mistake right?

The unfortunate answer is an unequivocal NO!

This is no mistake!

Why do landlords want a Personal Guarantee?

Let's start back at the beginning by understanding what exactly a lease is in the first place.

A lease is a conveyance of real property for a tenant to use the property for a fee.

You the tenant do not own the property; therefore the right to use the property will be for a limited amount of time. The lease document sets forth all the terms and conditions under which a landlord will "rent" a tenant their property.

A lease is also a financial instrument. It's a way of using a piece of commercial property without having to buy it etc. The landlord is "conveying" the use of the property to what they believe is a financially responsible entity that will use the property in a proper manner. All leases require tenants to pay the rent without demand. This means the landlord will not be sending monthly invoices for the rent. The landlord relies on the good faith and financial wherewithal of the tenant to pay what has been agreed upon. Otherwise the landlord could have rented the property to another whom they felt was a better financial risk.

So why does the landlord require a personal guarantee? There are a few answers to this question. The best way to understand this is to put yourself in the landlord's shoes.

Lets take a look at who you are as a small business tenant.

1. You are most likely a "start-up" operation with little to no operational history or credit facilities at your disposal.
2. The entity you formed, no matter what legal form its in, usually has no net worth.
3. Even if your company is "making money" all the profit goes from the business to you as an individual. This means the business entity has no retained earnings or large assets or pools of cash in the form of stocks and bonds or other securities. The company has no value other than you the owner.
4. In the event you have hard assets such as machinery, computers, automotive assets, inventory etc, there is a very high probability these assets are secured by lien holders such as banks and/or finance companies. The landlord actually would have signed a waiver of making any claim to the hard assets.
5. You are a franchisee, which means you are a small business with doing business with name recognition and a proven process. It does not mean you are a good business person or manager. It does not mean your franchisor has

Guaranteed" the lease on your behalf. In the vast majority of cases franchisors do not and will not guarantee their franchisee's leases. Some of the larger franchisors may actually have gone out and leased the location and are subleasing you the property. But don't count on either their guarantee or then being your sub-landlord.

So what this means to the landlord is in the event of a default of the lease by you the tenant, the landlord has nothing to go after in order to get the rent that is owed.

You may want to ask yourself, well why would the landlord care if we default on the lease/rent? The landlord owns the property and hence has the ability to re-lease to someone else. And that is a very fair question in which there is a further answer.

Depending upon what type of space you are occupying meaning retail, office or industrial, will matter to what extent the landlord will want you to "guarantee the lease".

Lets take a retail landlord, who usually lease their space on an "as is" where is" basis. This means you as the tenant are required to all the interior improvements or fit-up at your own cost, expenses etc. The landlord hands you the keys to the space and that is it. In some cases the landlord will deliver the space in what is known as a "shell" condition. This means just how it sounds, you get 4 clean walls, a dropped ceiling (in some cases) HVAC basic plumbing, electrical outlets and no floor coverings. The reason the space is delivered in a shell condition this due to the fact that every retail user has their own unique interior finish. Therefore the landlord has made virtually no investment into your business other than providing you with a roof over your head. It is also most likely that you financed the construction of your interior retail space. Unfortunately these improvements have little to no value to either the landlord or the lender. There is no residual use for these specialized finishes, as the next retailer will want the space gutted and presented in a shell condition just the way you got it when you took the space. However, what the landlord does expect in return for permitting you to rent their space is the timely payment of the rent and all other associated

costs with renting the space. A default in a retail center harms a landlord do to the fact it makes a blemish to the retail center as it may portray a bad location etc.

The Office space tenant is different in that landlord's typically offer office tenants some TI allowance. This means the landlord will offer a office tenant some interior work based on a dollar amount to renovate the office area. If the space is brand new the amount the landlord will offer will be much more than if the space had been previously occupied.

You as a small office user will most likely take space that was previously occupied, and ask the landlord to make so interior layout changes. The landlord may offer to do just install new carpet and provide a new paint job. Market conditions in your area will dictate how much flexibility there will be in landlord's providing more.

Industrial is very similar to retail as the landlord's provide the industrial space users a "warm lit shell" with little to no other interior improvements.

What many tenants try and do, more so in office & industrial is have the landlord provide the extras they need and have the cost be financed within lease over the term. The landlord will input a financing factor into the equation; however, this deal component is directly related to the credit of the tenant.

Due to all the reasons stated above is why landlords want a personal guarantee.

They have reviewed your "personal" financials, they are OK with your intended use of the space and they have read your business plan. However the landlord is still taking a risk.

So ask yourself...what would you do if someone, a stranger, asked to borrow money from you? Would you just hand them the money with no strings attached? Of course you wouldn't!

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