

Corporate Communiqué

Rent or Buy? Part Two: Cost Factors

By Bernadette L. Puzzuole, Esq.

In our last issue, I outlined some issues to consider if you are contemplating either leasing or buying a space for your business, including zoning, tax ramifications, and financing. Once you have covered these topics, a cost analysis will help you finalize your decision to lease or buy.

Assuming your intended use is permitted in a location where there are both rental properties and properties for sale that will satisfy your needs, you then need to investigate the market. Find out the square foot leasing charges in that area, and the occupancy rate for similar type buildings before you decide to negotiate a lease. For properties for sale, check out the sale price, the appraised value, and the history of ownership for that and adjacent properties. You need to know what to offer, and whether the price is for a property in an area where prices are climbing, or declining.

Purchase Costs

If you believe based on your investigation, that you can afford the price the seller is asking for property you want, don't overlook other costs that will be incurred both at acquisition and over the term of ownership. When you offer to buy property, you typically must provide hand money to the seller to make the purchase agreement binding. If you are going to finance the property, the bank will insist that you make a down payment so that the bank is not paying the total purchase price, and there is some equity in the property. There will be a loan application charge, and the bank may insist on a survey, building inspection, environmental inspection, and title insurance to protect its investment. All of these will be costs you will need to pay. Even if you are not financing the purchase, you should have the building inspected and, if a title search reveals any prior uses of the property that could have created environmental problems, you should have an environmental inspection performed. An owners title insurance policy is also a good thing to have to protect your investment. There will be transfer taxes to be paid (this is negotiable, but typically the buyer and seller split the costs equally) at closing.

Leasing Costs

If you decide not to purchase space, but instead to lease space in, for example, an office building or strip mall, you may know what the rental costs are, but, just as with a purchase, that monthly rent will not be the only cost you pay.

In most multi-tenant spaces, all tenants have what are referred to as common charges, typically the costs of providing utilities to, cleaning, maintaining and repairing the entrance way, hallways, and shared restrooms, and removing snow and ice from the walkways and parking areas. These common charges are a monthly charge in addition to your monthly rent under

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the lease. Your share of the common charges is typically determined by comparing the size of your space with the size of all other leased spaces. You need to review this calculation carefully, however, to be sure that the calculation is appropriate.

If the utilities to your space are not separately metered, you will be sharing the costs of heating, cooling, providing water to, and lighting the entire building, or a portion of the building under the same metering, again based on some calculation that needs to be carefully reviewed. You also need to ensure that the monies paid in common charges and shared utility charges are used for their intended purpose, and not used by the landlord to pay some other costs of the landlord. This can be done by negotiating the right to audit the landlord's books associated with the building as part of the lease, or otherwise securing proof that the charges assessed are actual charges, and are paid when due.

In addition to common charges, the lease may provide that you share in the costs of insurance and real estate taxes on the building, or any increases in those costs above the amount specified in the lease. This can be a lease provision even if you are the sole tenant for the space, and in that case, all the increases in insurance and taxes would be paid by you. You, of course, will need to insure your own property in the leased space, and will want general liability insurance as well. The lease may require that the landlord be named as an additional insured on that insurance.

The lease may also require the tenant to maintain the space rented, including plumbing, wiring, and HVAC, and it may even require the tenant to share the costs of roof repairs and major structural repairs for the building. Modifications to the leased space required by changes in law (e.g., the ADA) may become the obligation of the tenant under the lease.

Additionally, any space not in move-in condition will require the expenditure of funds to make it suitable for your purposes. How those costs are treated needs to be addressed. The range of possibilities can extend to the tenant paying all renovation costs, the landlord paying all renovation costs, or even the landlord advancing all renovation costs and then amortizing them over the term of the lease, to be paid as additional rent over the term of the lease.

Another factor may be increases in rent. There may be a yearly escalation provision in the lease, allowing for increases that are either specifically negotiated or are based on an increase in the cost of living. Increases can also be a factor when it is time to renew a lease.

Many of these items can be negotiated, and so the assistance of legal counsel in negotiating a commercial lease is always a good idea.

HYBRID – THE OFFICE CONDOMINIUM

In recent years, some developers have been creating office condominiums. These hybrid ownership forms are similar to residential condominiums, but are not governed by the Pennsylvania laws applicable to residential condominiums.

With an office condominium, you purchase your space in a larger complex, rather than lease that space. And, rather than paying a share of the costs of the common areas owned by the landlord, you actually would have an ownership interest in those common areas, and pay a share of the costs associated with those common areas based on your ownership interest. What those costs would be and how they would be assessed would all be disclosed in the condominium documents. The condominium documents may also contain restrictions on how you use your space, and restrict your ability to sell your space in the future. If you are considering this type of purchase, you should clearly have legal assistance.

OTHER ISSUES

Property ownership allows you to build equity in the property, so that, while a tenant in 10 years has rent payment receipts to show for its investment, a property owner has built up equity in the property, and that has a separate value which can be marketed. Of course, if the value of the property has not increased, that equity may not be as valuable as the expenses incurred in obtaining it.

Determining how large a space to purchase or lease is also important, as you consider the growth of your business. While growth is generally regarded as a good thing, if you've purchased property that won't accommodate that growth, growth is a mixed blessing. You may find that you need to sell that space and move to a larger location. Changes in the real estate market since the day you purchased the property can lead to a good or bad result when you try to sell. In a leasing situation, the transition may be easier if you are not in a long-term lease.

If purchasing, therefore, you may want to purchase a location larger than you currently need, and lease the extra space. Then, if you need to expand, the space will be available once the other lease ends. And during that third party lease, the rental income can help defray your purchase costs. In this case, because the rental income will be from other than your business operation you should

seriously consider purchasing the property in an entity different from your business.

Real estate presents special challenges for business owners. Doing your homework and consulting with professionals as needed will, in the end, save you time, money and aggravation so you can focus on building your business.



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Workouts

By Paul R. Yagelski, Esq.

During these difficult economic times, almost everyday we read in the news and see on television that businesses, whether small or large, are having difficulty meeting their expenses. Many are closing their doors. When this happens, it is not unusual to have lingering bills and other obligations. Suppliers and other creditors may not be paid and in many cases, owners are left with outstanding guarantees. What are the options when a business, particularly a small or medium sized business, decides to close its doors? Can the creditors be paid? Is it possible to get the owners of the business released from their guarantees? What can be done?

One of the first options that an owner normally considers is filing a Chapter 7 Bankruptcy. However, bankruptcy is only one tool available to a troubled business and in making a decision, the owner should consider multiple options before moving forward. These can include, among others, the sale of the business, liquidation through a private/public sale or auction, and, of course, bankruptcy. To select an option, consider what the owner wants to accomplish. Which option will best serve the interests of the owner? Which option will pay as many creditors as possible? Whichever option is chosen, the needs of the owner are normally of paramount importance.

One of the first options that should be considered is the sale of the business. Whether a business can be sold will depend on a number of factors. For example, does the business have a marketable product? What is the cash flow? What are the expenses? There are many business brokers that can be consulted to see if the business can be sold, whether in its entirety (i.e., assets and liabilities), or, more often than not, just the assets, including good will.

If the business can't be sold, liquidation is an option and there are various ways to liquidate a business. One of the first that should be considered is whether the business can be wound down, but still operate without buying new inventory while selling the existing inventory to pay as

many creditors as possible. Sometimes this isn't possible, as word will get out that the business is liquidating. In that event, accounts receivable may dry up and suppliers may put the business on COD.

Another liquidation option would be to conduct a going out of business sale or a public auction. In this option, all of the business' merchandise and equipment would be sold at one time or over a short period of time. The goal here is to generate a pool of cash and then offer a workout or composition to creditors in which creditors would be paid on a pro-rata basis to satisfy their outstanding obligations at a much lower amount than what is owned, but hopefully, at a much higher amount than would be obtained through a bankruptcy.

Whichever option is chosen, once the inventory, equipment, and other saleable assets have been sold, a plan must be put together to pay secured and unsecured creditors, taxes, any outstanding rent, outstanding guarantees, etc., from the cash received.

In devising a plan, consideration must first be given to any outstanding taxes, particularly trust fund taxes or taxes for which the owners may be responsible. Consideration must then be given to any secured parties. This is usually a bank that has a security interest in inventory, equipment, accounts - just about everything. If all the moneys obtained have to go to pay taxes and secured parties and there is nothing left for other debts, then serious consideration should be given to placing the business into a Chapter 7 bankruptcy.

It is not unusual however, to have money left over after taxes and secured creditors are paid or there may not be any secured creditors. In either case, if there is still money available, consideration should then be given to relieve the owner of any obligation on personal guarantees.

As to suppliers and other unsecured creditors, this class of creditors is normally last on the totem pole for

payment. If monies are available, letters can be sent to the unsecured creditors offering a composition.

Lastly, bankruptcy is always an option. Business owners should note however that bankruptcy will not help an owner of a business if the owner has personally guaranteed any obligation or if there are trust fund taxes owed. In such a situation, a Chapter 7 bankruptcy is not a viable option, as the bankruptcy will liquidate assets but many creditors may not be paid and these may include debts that have been guaranteed by the owner of the business. A liquidation outside of the bankruptcy will generally allow the owner to prefer the creditors that he wants to be paid. A disadvantage of bankruptcy is that such a preference normally can't be done, as the bankruptcy law directs the order of payment, thereby potentially leaving an owner liable on an outstanding guarantee. If there are no guarantees or trust fund obligations owed, and in particular, if the owner of the business does not have an objection to filing for bankruptcy, then a bankruptcy should be seriously considered.

Whatever option is chosen, the goal of the owner(s) of the business should always be of paramount importance. This, along with the business' obligations and assets, always needs to be considered before

deciding on the best option. At times, a combination of options may be available, e.g., a private liquidation and then a bankruptcy filing.

If you know of anyone who is having distress in their business to the point that they are considering closing their business, the owner should consult with an attorney, preferably an attorney who is experienced in workouts and/or has creditors' rights experience. Very often a successful workout can be done. Consult an attorney before a decision is made.



Paul Yagelski was certified by the American Board of Certification in the field of Creditors' Rights in 2002 and recertified in 2007 through a rigorous process of practice, peer review, and continuing education. In addition to his Creditors' Rights practice, Paul also has a robust civil litigation practice that includes commercial litigation, tort litigation, remedial litigation, tax litigation and bankruptcy actions, with extensive involvement in Chapter 11 proceedings. Paul has litigated before state and federal trial courts and the American Arbitration Association. Paul can be reached at (412) 338-1124 or pryagelski@rothmangordon.com

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