

RETAIL & OFFICE LEASING



Retail Leasing: Unique Issues and Major Differences Between Retail and Office Leasing Negotiations

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I. OVERVIEW

The negotiation of a retail lease for a shopping center—whether it is a regional mall, strip center, power center, or lifestyle center—involves a number of issues that are unique to the retail environment. Those issues highlight the major differences between retail and office leases and include the following:

- A. In retail lease negotiations, distinctions are made between major tenants (sometimes called “majors”) and smaller, inline tenants. Major tenants have substantial bargaining power and, as a result, can often successfully negotiate significant economic concessions and rights to control the operation and appearance of the shopping center.
- B. Although a retail tenant’s covenant to pay rent is a major component of the lease, there are other tenant covenants that are important in the retail context. Because the success of a shopping center depends on attracting customers, landlords require retail tenants to be open and operating and, accordingly, include opening and operating covenants in their leases. Similarly, major tenants expect other tenants in the center to be open and operating. As a result, major tenants require landlords to agree to “cotenancy conditions.” If certain other named cotenants are not open and operating in the shopping center, or if a specified percentage of the leasable space in the center is not open and operating, the major tenant will negotiate lease remedies, including the right to pay a reduced rent and the right to terminate its lease.
- C. The particular use of the premises and the tradename under which a retail tenant operates are heavily negotiated in a retail lease. These issues are not of such importance in an office lease.
- D. Exclusive use rights are often granted to major tenants in shopping centers (e.g., ABC Toy Store shall have the sole and exclusive right to operate a toy store in the shopping center). Exclusive use rights benefit the recipient tenant by limiting direct competition. The granting of exclusives, however, greatly

complicates leasing of a shopping center not only for the landlord, but for new tenants coming into the center. Exclusive use rights are rarely found in office leasing.

- E. Assignment and subletting provisions are found in both office and retail leases but they are particularly important in the retail context because landlords want to control the tenants and the type and quality of the merchandise sold in the shopping center. As a result, these provisions are heavily negotiated. Landlords negotiate for limitations and control, while tenants bargain for flexibility so they can assign or sublease to a broad range of assignees or subtenants.
- F. Finally, retail tenants typically do not just pay a base rent and a share of operating expenses like office tenants. They often pay percentage rent that is based upon a percentage of their gross sales. They may also pay promotional fees and advertising charges to reimburse the landlord for its costs of advertising and promoting the shopping center. This article examines these issues as a primer for the general practitioner or new lawyer handling a retail lease, including a review of terminology and other concepts integral to the unique retail environment.

II. MAJOR TENANTS VERSUS INLINE TENANTS

In retail leasing landlords make distinctions between major tenants and inline tenants (i.e., those smaller tenants located “inline” between the major tenants that often “anchor” the ends of a mall or a strip center). The relative bargaining power of the landlord and tenant is a significant factor in the negotiation of any lease. In the retail context, “major tenants” have the leverage to negotiate significant lease concessions that not only affect the landlord, but other tenants in the center, as well. There is no single definition of a major tenant. Rather, they are often defined by the type of shopping center in which they are located. In a regional mall, a major tenant would be a department store. In a strip center, a national or regional grocery store, a big box tenant, or a theater might be considered a major tenant. In a power center, which is comprised primarily of large tenants like, for example, Costco, Target, or Home

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Depot, with a few small inline tenants, each large tenant might be considered a major tenant.

Major tenants are treated differently from inline tenants and are able to negotiate significant lease concessions successfully because they are considered destination tenants. They draw customers to the shopping center. Because their presence is considered a benefit to the landlord and the other smaller tenants of the shopping center, major tenants can successfully negotiate favorable lease terms, including economic concessions. Typically, the major tenant will not pay interior common area maintenance charges in an enclosed mall (e.g., costs to heat, light, maintain, and clean the interior mall). They may pay no or a reduced share of exterior common area charges (such as the costs to maintain and clean the parking area). Major tenants frequently negotiate an annual cap on the amount of common area charges that they must reimburse each year regardless of the actual costs. They may pay no or a reduced share of the landlord's real estate taxes. They rarely pay promotional fees or marketing charges for the center.

Majors often negotiate rights to control the appearance and operation of the shopping center. Major tenants have the right to approve changes to the common areas of the shopping center within a designated "control area." This control area typically includes the sidewalks, driveways, and parking areas in front of the major's premises and may also include the primary entrances to and driveways of the shopping center. Majors want to ensure that landlords cannot alter parking fields, access routes, and the flow of traffic in proximity to the major's premises in a manner which the major tenant would consider detrimental to its business or use of its premises. Majors often have the right to approve the size of the signage of other tenants, the design and color of building exteriors, and the storefronts of other tenants (including color, design and height). Majors want to ensure that the signage and storefront size and height of inline or other nonmajor tenants does not exceed the size and height of the major's signage and storefront. Majors get priority positions on shopping center pylon and monument signs. Major tenants often negotiate the right to assume responsibility for the maintenance and repair of the common area in their portion of the shopping center, at their sole cost and expense, in lieu of reimbursing the landlord for such common area maintenance costs. If a landlord is not properly maintaining the common areas, a major may want the right to step in and handle the maintenance and repair for their portion of the shopping center. As is discussed in Sections IV and VI, major tenants often have the bargaining power to negotiate favorable exclusive use rights and cotenancy rights.

The lease concessions granted to major tenants have an impact on both the landlord and the other tenants in the center. If a major tenant has the right to approve changes to its "control area," the landlord who wants to reconfigure the parking lot or relocate driveways within the control area as a part of the redevelopment of the shopping center will have to obtain the major's consent. If the lease for Major A says that no other tenant may have a storefront height which exceeds the storefront height of Major A, then a new tenant coming into the center will be subject to that height restriction. While this limitation may not be a problem for a small inline tenant, a national retailer ("Major B") that has a prototype storefront design

that exceeds the Major A height limitation, may well object to that limitation. The landlord must then ask Major A to waive its height restriction as to Major B or risk losing the opportunity to sign a new lease with Major B.

The economic concessions granted to a major tenant have an economic impact on the inline tenants. If a major tenant has negotiated the right to pay a reduced share of common area charges and no real estate taxes, the inline tenants pay a disproportionate share of these costs and thereby subsidize the major tenants. The justification for the subsidy is that the majors are the primary customer draw for the center that benefits the inline tenants.

III. USE CLAUSES AND TRADENAMES

As opposed to office and industrial leases, use clauses and tradenames restrictions are heavily negotiated in retail leases. Landlords, particularly of enclosed malls, strive to maintain a good mix of quality tenants and merchandise that will attract customers. Landlords also want to avoid overcompetition by having too many retailers with similar uses operating in the center. To achieve these goals, landlords try to negotiate in each lease a narrowly defined "permitted use" that makes it clear what a tenant can and cannot sell in its store (e.g., "the premises shall be used for the sale of apparel and shoes for children and for no other purpose"). If the landlord wants to guarantee that there is one children's apparel store in its shopping center, it will want to make sure that the use clause negotiated for the children's apparel retailer is narrow enough so that the retailer will not convert its use to something else. Landlord will require the tenant to operate under a specified tradename as the tradename helps the landlord control the use of the premises and also ensure retail name recognition that draws customers. If a landlord has leased space to a nationally recognized women's apparel retailer, the landlord does not want that retailer to convert its use to the sale of children's wear or to change its store to a new concept under a brand new tradename which is not nationally recognized and will not be the same customer draw. The landlord's rationale is that it bargained for a nationally recognized tenant and made rent and other lease concessions in order to induce that specific nationally recognized tenant to sign a lease. The landlord also wants a narrow use clause and tradename restrictions in order to control the tenant's ability to assign or sublet to a third party, so that the landlord maintains control over the mix of tenants and merchandise in the center, even if a lease is assigned or the premises sublet to a new retailer. The landlord's success in negotiating a narrow use clause depends on the bargaining power of the tenant. Major tenants often insist on the right to engage in "any lawful retail use" and will not agree to a specific permitted use.

Although all tenants benefit from being in a diverse shopping center with a variety of stores selling different types of merchandise, when a tenant negotiates its own lease, its goal is to maintain flexibility to alter its use and tradename. Because the retail business is competitive and constantly changing, tenants argue that they need the flexibility to change product lines and to introduce new retail concepts and do not want to be prevented from doing so by overly restrictive use and tradename clauses. Tenants also want a broader

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use clause as part of an exit strategy, so it is easier to find a successor tenant should it be necessary to assign or sublet.

A retail tenant needs the ability to change its tradename in order to adapt to changing markets, remain competitive, and evolve their retail business. Accordingly, a tenant with a tradename restriction may negotiate the right to change its tradename to a new tradename used by that tenant in a majority of its stores in a particular geographic region. That way, if the tenant creates a new retail concept with a new tradename and intends to convert all of its stores in a particular geographic region to that new concept, it will have the ability to do so.

In addition to the specific use clause that is negotiated in a retail lease, landlords can impose additional use restrictions by imposing certain "prohibited uses." Prohibited uses are typically undesirable uses (at least in a shopping center setting) such as flea markets, adult bookstores, manufacturing operations, automotive repair facilities, bars, and nightclubs. If a major tenant has successfully negotiated an "any lawful retail use" clause, these prohibited uses are often the landlord's only way to control that major tenant's use. Major tenants, too, often want certain uses prohibited in the shopping center and accordingly require the landlord to covenant in the major tenant lease that certain uses (in addition to the typical undesirable uses) will not be permitted anywhere in the shopping center or within a certain distance from the major tenant's premises. The major tenant is concerned with uses in close proximity to the major's premises that will take up too many parking spaces ("high intensity parking uses"), create excessive noise or loud music, generate excessive trash, or disrupt traffic flow through the parking lot. For that reason, major tenants often restrict the locations of restaurants, theaters, health clubs, car washes, and facilities for the sale of auto parts and car repairs. Major tenants, too, want to limit the amount of office space that can be included in a retail center, as office uses take up retail space (and parking) but do not draw customers to the center.

Another complexity of retail leasing, which is not found in office leasing, is the interplay between use clauses and exclusive use rights. When negotiating the use clause, both the landlord and tenant need to be aware of exclusive uses that the landlord has already granted to other tenants. If a landlord has granted an existing tenant the exclusive right to sell toys and that landlord is negotiating a new lease with a children's apparel retailer (that may sell some toys on an incidental basis), the landlord needs to be sure that the new tenant's use clause does not allow the sale of toys, which would permit a violation of the existing tenant's toy exclusive. On the other hand, a new tenant negotiating a lease should require a full disclosure from the landlord of all existing exclusives so the new tenant can determine whether those existing exclusives will unduly restrict its ability to operate in its customary manner.

IV. EXCLUSIVE USE RIGHTS

Granting exclusive use rights, or "exclusives," to tenants is common in retail leasing but rare in office leasing. Major tenants often require landlords to grant them the exclusive right to sell certain merchandise or to operate their particular use in the

shopping center and to covenant not to lease space to another tenant for the same use (e.g., national toy retailer "Toys For All" requires the landlord to agree that "no tenant or occupant of the shopping center other than Toys For All may use in excess of 500 square feet of gross leasable area of its premises for the sale of toys"). The rationale for an exclusive, from the major tenant's perspective, is that it limits its direct competition in the center. Landlords grant exclusives because they are often compelled to do so in order to induce a major tenant to sign a lease.

The granting of exclusives complicates the leasing of a shopping center for both the landlord and new tenants who want to lease space in the center. Exclusives affect the landlord's lease negotiations with a new tenant because those exclusives will restrict the new tenant's permitted use. Vague, ambiguous, and poorly worded exclusives further complicate lease negotiations with a new tenant. Example: Landlord has granted an exclusive to a sporting goods store for the sale of sporting goods and sports apparel. The exclusive does not define "sports apparel." An apparel retailer wants to sign a new lease at the center, but sells items such as tennis shoes, sweatshirts, t-shirts, and baseball style caps. Do these items constitute sports apparel that would violate the existing exclusive? What if the sporting goods exclusive allows the sale of sporting goods by another tenant on an "incidental basis," but there is no definition of "incidental basis"? Can a new tenant sell sporting goods from five percent of its premises or 50% of its premises? A new tenant that sells "sports apparel" or some sporting goods will likely require the landlord to obtain a waiver or clarification from the existing tenant (with the exclusive) before that new tenant is willing to sign a lease for that center. To avoid the unintended consequences of poorly drafted exclusives, landlords should negotiate narrow and clearly worded exclusive use rights and clear exceptions that will allow future tenants to sell some of the other tenant's exclusive items on an incidental basis (and clearly define what is meant by "incidental basis").

The remedies for a violation of a tenant's exclusive use right are heavily negotiated. Major tenants want all remedies available at law and in equity, plus the right to start paying a reduced rent immediately, and the right to terminate the lease if the exclusive violation continues for a specified period of time. Landlord may negotiate for a grace period before any remedies become available to the tenant if the exclusive use violation was caused by a "rogue tenant" and was not due to the act or omission of the landlord. The grace period allows the landlord time to stop the exclusive use violation before the major tenant can exercise its remedies. Landlord may require the major tenant to prove lost sales or other detriment arising from the exclusive use violation before the tenant can exercise its remedies. Landlord will require that the exclusive terminate if the tenant "goes dark" and ceases operating in that center. (As discussed in Section V, some tenants have opening and operating covenants. However, major tenants often do not. They have the right to "go dark" and as long as they continue to pay rent and observe other terms of the lease, their closure is not a breach of the lease.) Otherwise, the tenant could go dark and open a new store in a nearby competing shopping center but still prevent landlord from leasing space in the old center to a competitor by enforcing the exclusive use rights in its existing lease.

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V. OPENING AND OPERATING COVENANTS

Opening and operating covenants are unique to retail leasing. Because the success of a shopping center depends on attracting customers, landlords will negotiate express lease covenants that require tenants to open for business by a specified date and to thereafter continuously operate specified days and hours. In a new center, the landlord may establish a grand opening date and require all of the tenants to open by that date. If a tenant misses the grand opening, in addition to constituting a default, the landlord may impose per diem liquidated damages for each day the tenant fails to open. The tenant will often negotiate exceptions to its obligation to open. For example, a tenant will condition its obligation to open by the grand opening date on the landlord delivering the premises by a specified date, which date is far enough in advance of the grand opening date that the tenant has adequate time to build out its tenant improvements and to stock and staff fully the premises for business. One tenant's opening covenant may be contingent upon other named tenants in the shopping center (or a specified percentage of other tenants in the center) also being open. The reason is that no single tenant wants to open in a new center unless a significant number of other tenants are also opening at the same time. Tenants with operating covenants will typically negotiate rights to close due to force majeure events, in order to perform repairs and remodeling and to take inventory. Not all tenants have opening and operating covenants. Department stores generally agree to such covenants as long as the other department stores in the center have the same covenants. Major tenants, particularly in non-mall centers, avoid agreeing to these covenants, but may, as a compromise, agree to open for at least one day. Majors want the right to "go dark," but may agree that if they "go dark" for an extended period of time the landlord may terminate the lease and "recapture" the premises. Inline tenants will give opening and operating covenants, but these covenants may be subject to other tenants in the center also operating the same days and hours.

Opening and operating covenants tie in directly with the tenant's obligation to pay a percentage rent (discussed in Section VIII). The landlord wants to maximize the percentage rent that the tenant pays and does so, in part, by requiring the tenant to continuously operate. Opening and operating covenants in one lease also tie in directly with cotenancy rights that the landlord may have granted to tenants (discussed in Section VI).

VI. COTENANCY RIGHTS

Cotenancy rights are another concept unique to retail leasing. Retail tenants in a center depend on the synergy of a group of retailers to attract customers. If a tenant is negotiating a lease at a particular center with the expectation that certain national retailers will also be operating in the center, the tenant may negotiate lease rights ("cotenancy rights") that will give it remedies if those national tenants do not operate as expected. Typically, cotenancy rights in a lease give a tenant remedies if certain named cotenants and/or tenants occupying a minimum percentage of the total gross leasable area ("GLA") of the shopping center are not open and operating in the center. Cotenancy provisions are drafted as a condition, which, if not satisfied, gives tenant a remedy and not as a landlord

covenant giving rise to a landlord breach and a tenant right to claim damages if the landlord does not satisfy the cotenancy requirements. A sample cotenancy requirement reads as follows:

- A. The "Cotenancy Requirements" shall be satisfied when the Required CoTenants (identified in Clause (B) below) plus retail stores (other than the Premises and the Required CoTenants) having an aggregate of 70% or more of the total GLA of the Shopping Center (other than the Premises and the Required CoTenants) are also open for business during the Required Times. Required Times shall mean 10:00 a.m. to 6:00 p.m. daily except public holidays. A "Cotenancy Violation" occurs when the CoTenancy Requirements are not met.
- B. The Required CoTenants are the retailers operating under the following tradenames and occupying not less than the required GLA indicated:

Tradenname	Required GLA
XYZ Toys	40,000 sq. ft.
AAA Apparel	20,000 sq. ft.

Typically, if there is a cotenancy violation, then during the period of the violation the tenant will have the right to pay, in lieu of all rent due under the lease, a "substitute rent" that is often defined as the lesser of (i) the regular base rent payable under the lease, or (ii) a percent (e.g., two percent) of tenant's gross sales for each month. If the cotenancy violation continues for an extended period of time (e.g., twelve months) the tenant may have the right to terminate the lease.

Granting cotenancy rights creates significant risks for the landlord. First, the landlord should avoid giving opening cotenancy rights because of the possible domino effect of one tenant's failure to open on another tenant's obligation to open. Example: Tenant X, Tenant Y and Tenant Z all have signed leases in a new center. All have opening covenants; however, they all have cotenancy rights as well. The Tenant X lease says Tenant X has no obligation to open unless Tenant Y is open. The Tenant Z lease says that Tenant Z has no obligation to open unless Tenant X is open. Tenant Y fails to open on time. There is now a cotenancy violation under the Tenant X lease. If Tenant X elects not to open, there is now a cotenancy violation under the Tenant Z lease and Tenant Z has no obligation to open.

The landlord tries to limit cotenancy rights in various ways. First, it will try to limit any cotenancy conditions to one condition. Either certain named required cotenants must be open, or a certain percentage of the tenants in the shopping center (or a percentage of the total GLA of the shopping center) must be open. Landlord does not want to have to satisfy both conditions. Landlord will try to limit the cotenancy condition to a percentage of the actual tenants in the shopping center rather than a percentage of the total GLA of the shopping center and will try to avoid naming specific required cotenants. If landlord is developing a new center, it does not know a year or two in advance which tenants will ultimately sign leases. Therefore, rather than naming specific retailers as required

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cotenants, landlord would prefer that the lease state that the shopping center must be occupied by at least three nationally recognized anchor tenants, with an anchor tenant being defined as a tenant that operates at least 100 stores nationally. Conversely, landlord will want the lease to state that any named cotenant can be replaced by a "comparable replacement tenant."

The landlord tries to limit a tenant's remedies if there is a cotenancy violation. If a tenant has an operating covenant in its own lease, landlord does not want that tenant to have the right to close because of the cotenancy violation. As illustrated above, allowing one tenant the right to close may have a domino effect by creating cotenancy violations under other tenant leases. The landlord may require that the tenant prove actual detriment, such as lost sales, due to a cotenancy violation, before tenant has the right to pay reduced rent. The landlord will also require the tenant to be open and operating and not otherwise in default before it can exercise any cotenancy remedies.

As to substitute rent, landlords want substitute rent to be in lieu of the regular minimum rent and percentage rent only (not tenant's share of operating expenses). From the landlord's perspective, the center still needs to be operated and maintained; therefore, the tenant should be required to continue to pay operating expenses. If landlord must give the tenant a termination right, landlord only wants the termination right to apply if the cotenancy violation has continued for an extended period of time, such as one to two years. On the other hand, landlord does not want the tenant to be able to pay substitute rent for an extended period of time. Landlords frequently negotiate a "fish or cut bait" provision whereby, if the tenant has paid substitute rent for twelve months, the tenant must then elect either to terminate the lease or to resume payment of regular rent. Alternatively, landlord will negotiate a landlord right to terminate the lease if the tenant has paid substitute rent for an extended period of time, (e.g., twenty-four months), and has not elected to terminate the lease. Landlord does not want to be forced to keep a tenant that is paying a reduced rent. It may prefer to terminate that tenant's lease and start again with a new tenant.

The landlord may negotiate a waiting period before the tenant can exercise any remedy, for example, the cotenancy failure must continue for six consecutive months before tenant can start paying substitute rent. This gives the landlord time to cure a cotenancy violation before the tenant's right to pay reduced rent kicks in.

Landlords will also negotiate "excused closures" that are typically closures due to casualty, repairs, and remodeling. This means the required cotenant's store is not considered closed for business during the period of an "excused closure" and a tenant with cotenancy rights cannot claim a cotenancy violation if a required cotenant is closed by reason of an excused closure. On the other hand, a tenant with cotenancy rights will want to limit periods of excused closures, for example, to a maximum of 120 days. After the 120 day period expires, the required cotenant's store will be considered closed for purposes of satisfying the cotenancy requirements. Even if a cotenant's store is closed for a good reason, it is still closed and the tenant who negotiated cotenancy rights wants to exercise its remedies.

VII. ASSIGNMENT AND SUBLETTING

Assignment and subletting provisions are in all leases, but they are particularly important in retail leases and are heavily negotiated. Negotiations reflect the tension between the landlord's need to control the character, quality, and balance of retailers in the center and the tenant's desire for flexibility so it can transfer its premises to a range of possible successor tenants. In regional malls, a landlord will insist on the right to consent to an assignment or sublease in its sole discretion (at least in leases for inline tenants). In a major tenant lease, a landlord may agree that its consent will not be unreasonably withheld. Even in that case, however, the landlord may negotiate a list of criteria that the landlord can consider when asked to consent to a particular assignment or sublease. The lease will state that it will not be unreasonable for landlord to withhold its consent if the proposed assignee or subtenant does not meet those criteria. Typical criteria considered by a landlord include the following:

1. The creditworthiness of the successor tenant. Is the net worth of the proposed transferee comparable to that of the tenant it is replacing?
2. What is the proposed use of the premises? This ties in directly with the use clause which has been negotiated in the lease. The landlord may take the position that the tenant can only assign to a successor tenant who will operate the same use. Tenant will not want to be so limited. As a compromise, even where the tenant has a narrow use clause, the tenant may get the landlord to agree to permit an assignment or sublease for "any retail use typically found in comparable shopping centers." Or, the tenant may agree not to assign or sublet to a use that is the same as the primary use of another tenant in the shopping center. This compromise gives tenant some flexibility but also ensures the landlord that there will not be duplicate primary uses in the center.
3. Is this successor tenant comparable to the tenant it is replacing? Does it have a comparable prominence in the retail industry? A comparable number of stores? A landlord that originally leased space to a national tenant with a chain of 300 stores and a recognized tradename may not want that tenant replaced by an unknown retailer with a single store or even an experienced retailer operating under a brand new tradename, as it may not be the same customer draw.
4. Will the proposed tenant generate a comparable level of sales? This will directly affect the percentage rent that the landlord receives. If sales of a proposed transferee are not comparable, the landlord may require, as a condition to its consent, that the proposed transferee agree to pay increased minimum rent to compensate for the anticipated loss of percentage rent.

The negotiation of assignment and subletting provisions in one lease may be affected by any exclusive use rights granted by landlord to another tenant. Landlord wants the use of any assignee or subtenant to be subject to any exclusives existing at the time of the assignment or sublease. The tenant will resist, arguing that its

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lease should be exempt from any exclusives granted after the date of its lease and that, accordingly, any assignee or subtenant should also be exempt from such exclusives.

Negotiation of the assignment and subletting clause will be affected by a landlord's cotenancy obligations to other major tenants. For example, landlord has agreed in Tenant A's lease that "Electronics World" or another national electronics retailer is a required cotenant in the shopping center. When landlord negotiates the assignment clause in the "Electronics World" lease, landlord will want to limit "Electronics World's" right to assign or sublease to only another national electronics retailer. Otherwise, the landlord's cotenancy obligations to Tenant A will be violated. On the other hand, "Electronics World" may object to this restriction as it too severely limits the range of prospective successor tenants, should "Electronics World" need to assign or sublet.

In the case of a proposed sublease, the landlord may want to prohibit the tenant from subleasing less than all of the premises. This is a particular issue in strip centers and power centers, which are often comprised of larger tenants. If a 30,000 square foot tenant wants to sublease its premises into three 10,000 square foot stores, those three replacement subtenants may not be the same draw as a single 30,000 square foot replacement tenant. In addition, subdividing large premises into smaller premises may well violate cotenancy clauses in other tenant leases. For example, if in Major Lease A the required cotenant is Major B (or comparable retailer) operating from at least 100,000 square feet, that requirement will not be satisfied if the Major B store is subdivided into two stores of 50,000 square feet each.

Landlords frequently negotiate a right to recapture the premises in the event a tenant wants to assign or sublet. This gives the landlord maximum control over the shopping center as the landlord can then control the releasing of those particular premises. The tenant's issues with a landlord's recapture right often relate to timing. The tenant negotiates for an "offer to surrender" instead of a landlord recapture right. If the tenant wants to assign or sublet, the tenant notifies the landlord and the landlord must advise the tenant within a fixed period of time (e.g., 30-60 days) that the landlord elects to recapture the premises and terminate the lease. If the landlord does not recapture within that time period, the tenant will have the right to assign or sublet the space (subject to landlord's consent, if required) and the landlord will have no further right to take back the space. Tenants do not want to have to spend time and money negotiating a lease assignment or a sublease and then have the landlord exercise a recapture right.

VIII. PERCENTAGE RENT, PROMOTIONAL FEES, AND MARKETING

The rent typically paid by retail tenants includes four components: fixed minimum rent, additional charges (which may include common area maintenances charges, taxes, and insurance charges), promotional and marketing fees, and percentage rent. Percentage rent and promotional and marketing fees are not paid by office tenants.

Promotional fees are a tenant's contribution toward the landlord's cost of promotional activities for the shopping center (e.g., holiday decorations and special promotional events for the center). A marketing or advertising charge reimburses the landlord for providing shopping center advertising to the media.

Percentage rent gives the landlord a share in the tenant's sales and is in addition to a fixed minimum rent. Retail tenants pay a fixed rent that is typically based upon a percentage of the expected sales from the premises. For apparel retailers, minimum rent is generally set at 5-6% of the projected sales; for food court tenants and video arcades, minimum rent should be 8-10% of sales; and for electronic retailers, minimum rent should be 4% of sales. Example: An apparel retailer leasing 3,000 square feet at \$100 per square foot pays \$300,000 in fixed minimum rent per year. Assuming that the \$300,000 represents 5% of the tenant's sales, then the \$300,000 in fixed minimum rent represents \$6,000,000 of sales. Percentage rent is in turn based upon the percentage of sales that the fixed minimum rent represents. For the first \$6,000,000 in sales, tenant is paying the fixed rent of \$300,000. For sales over \$6,000,000, landlord is entitled to additional rent. The 5% of sales over \$6,000,000 per year is called "percentage rent." The \$6,000,000 is called the "natural breakpoint," which is the point at which a tenant must start to pay percentage rent.

Tenants pay percentage rent in various ways. Major tenants often will not pay any percentage rent until after the end of each lease year. At that point, the major's gross sales are calculated and if percentage rent is due the tenant will pay all of the percentage rent due in one lump sum. Landlords prefer tenants to pay percentage rent monthly based upon a monthly breakpoint. Assuming the annual breakpoint is \$6,000,000, then the monthly breakpoint would be \$500,000 per month, and the tenant would pay monthly percentage rent of 5% of all sales over \$500,000 that month. Tenants, however, resist paying based upon a monthly breakpoint. They argue that they should not be paying percentage rent at all unless and until they reach \$6,000,000 in sales. If the tenant prevails in negotiations, the lease will be drafted so the tenant starts paying percentage rent when the tenant's sales for that year actually exceed the annual \$6,000,000 breakpoint.

Landlord and tenant will negotiate what is included in "Gross Sales" for purposes of calculating percentage rent as well as permitted exclusions from or credits against gross sales. A typical Gross Sales definition reads as follows: "Gross Sales are revenues received by tenant from the selling price of all merchandise sold in the store by tenant or its subtenants or licensees. . . ." Landlords want "Gross Sales" to be as all inclusive as possible, to maximize the percentage rent they receive. Tenants, however, negotiate specific exclusions and credits, which will reduce the Gross Sales upon which they must pay percentage rent. The exclusions and credits are often heavily negotiated. Typical exclusions from Gross Sales are insurance proceeds, sales taxes, and fees for customer services received by the tenant which are not at a profit (such as fees received by the tenant for merchandise mailing, apparel alterations, or delivery charges). Tenants will typically exclude subrents that they receive from a subtenant, although the subtenant's sales from the premises will be included in Gross Sales. Tenants will

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also try to negotiate credits against Gross Sales for uncollected accounts receivable and for the sales price of merchandise that is returned by a customer and accepted by the store for full credit (or by the amount of the cash refund given by the store for the returned merchandise).

In order for the landlord to know what percentage rent is due, landlord will require tenant to report its sales monthly and also on an annual basis. Landlord will also negotiate audit rights in order to verify the tenant's Gross Sales and to review the tenant's records of any exclusions from and credits against Gross Sales taken by the tenant.

IX. RADIUS RESTRICTIONS

Another concept unique to retail leasing is the radius clause. If a tenant is required to pay percentage rent, the landlord may negotiate a radius clause. This clause prohibits a tenant from opening another competing store within a specified distance from the shopping center. Landlord's rationale is that if tenant is permitted to open a competing store in close proximity to the original store, that new store will erode tenant's sales at the shopping center and thereby reduce the percentage rent paid to the landlord. A typical landlord oriented radius clause is as follows:

Radius Restriction. During the Term of the Lease ("Radius Term"), Tenant shall not own, operate, maintain, or control directly or indirectly a retail business similar to that conducted in the Store ("Competing Business") that is located or to be located within one mile from the Shopping Center ("Radius Area") without Landlord's prior written consent, which consent may be withheld in Landlord's sole discretion. Without limiting Landlord's rights or remedies, in the event of a breach by Tenant of these provisions, at Landlord's option, the Gross Sales from such Competing Business shall be deemed to be a part of Tenant's Gross Sales made from the Store for purposes of calculating the Percentage Rent payable by Tenant pursuant to the terms of this Lease.

There are a number of issues that must be addressed in negotiating a radius clause. The clause should include a clear definition of what constitutes a radius violation (e.g., tenant's operation of a Competing Business within the Radius Area during the Radius Term). Tenants will negotiate for a small Radius Area (e.g., one-half mile from the Shopping Center). Landlords typically want a three to five mile radius. Tenants will try to limit the duration of the Radius Term (e.g., the initial three years of the lease term). The key to the radius clause is the definition of Competing Business. Typically it is defined as a business operated by the named tenant

(or an affiliate) operating under the same tradename and carrying the same or similar merchandise.

With respect to the landlord's remedies in the event of a violation, the landlord will want to include 100% of the Gross Sales of the Competing Business in the Gross Sales of the Store, in addition to all other rights and remedies. Tenant will try to reduce the percentage from 100%, perhaps based on the location of the Competing Business, (e.g., the farther away the Competing Business, the lower the percentage of the Gross Sales included). Tenant will also try to negotiate that the inclusion of Gross Sales from the Competing Business is landlord's sole and exclusive remedy.

Tenant may negotiate certain exemptions and exclusions from any radius restriction. Tenant should exempt existing stores including renewals, extensions, and expansions of existing stores, and stores operated by the named tenant or an affiliate under a different tradename. A tenant may try to exclude certain named shopping centers within the Radius Area if tenant knows that it intends to open stores in particular competing centers, as well as stores in "street locations" (e.g., stores that are not located in a shopping center). A tenant will also negotiate for a termination of the radius restriction if there are cotenancy violations in the Shopping Center.

X. CONCLUSION

The negotiation of a retail lease involves a series of issues and concepts that are unique to the retail environment and distinguish the retail lease from the office lease. The relationship and interplay among the lease provisions that address these unique issues, both within a single lease and among the leases of multiple tenants in a shopping center, add a level of complexity to lease negotiations for retail leasing.

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