



RETAIL LEASE

RIGHTS & OBLIGATIONS

of a Landlord and a Tenant

By Thad Armstrong

Real estate industry experts are predicting that 2014 will finally see the retail market sector catch up to the rapid growth experienced in the last two years by the multifamily and office sectors.

A retail lease agreement can be complicated, with several aspects needing careful consideration; any one of these aspects could impact the success of both the landlord's and the tenant's business. Office leasing, on the other hand, is relatively straightforward. Sure, a tenant may select a certain space on a certain floor in a certain building for an office, but rarely will the office space itself be key to the success of its business. Not so with retail. Retail development has been described as organic—relying for success not only on levels of occupancy, but on the occupants themselves. Who are they? What are their businesses? How does each tenant fit into the mix?

Market and strategic considerations

are critical for both landlords and tenants. But so are contractual considerations. This article is intended to focus on the latter—the special rights and obligations of a landlord and a tenant in a retail lease contract.

Percentage Rent

Most tenants are used to paying two components of rent—a minimum monthly rent plus a share of expenses such as taxes, insurance, utilities, and maintenance. Retail tenants, however, frequently pay a third component of rent called “percentage rent.” Percentage rent, in its simplest form, is an amount of money payable by a tenant to a landlord based on a percentage of the tenant's sales. Percentage rent will be determined by three things: (1) the amount of gross sales, (2) the “breakpoint,” and (3) the applicable percentage. The applicable percentage is largely determined as part of the overall economic structure of the lease and then simply plugged into the

document. Understanding the other two rent components, however, is important when negotiating a lease contract.

First, the higher the gross sales, the higher the percentage rent. Landlords will want to take an inclusive view of gross sales, taking into account all sources of revenue from the premises. Tenants, on the other hand, will want to negotiate for as many deductions and exclusions as possible (e.g., returned merchandise, bad checks, and credit-card processing fees). The list of possible deductions and exclusions is long and highly negotiable. Second, the “breakpoint” is the dollar amount of sales over which percentage rent will apply. In other words, percentage rent will not apply unless and until the tenant's sales cross the breakpoint. Retail leases most commonly set a “natural breakpoint,” meaning the point at which the dollar amount of gross sales, when multiplied by the applicable percentage, equals the base rent. But nothing prevents a

landlord and a tenant from negotiating some other method for determining the breakpoint. Lower breakpoints favor the landlord, and higher breakpoints favor the tenant.

Requirement to Continuously Operate

Shopping centers depend on tenants being consistently open for business, to drive traffic not only to the center but from one retailer to the next within the center. Therefore, retail leases typically require the tenant to open for business and to stay open for business on a minimum number of days each week and for a minimum number of hours each day. A tenant with a good bargaining position may negotiate for the right to “go dark,” which means that the tenant may elect not to operate its business. “Going dark” is not a right to terminate the lease and does not mean that the tenant may avoid paying rent, but it does offer the tenant the flexibility to make business decisions about whether to continue to operate without the risk of defaulting under the lease. Landlords who agree to a tenant’s right to go dark will want to negotiate a right to “recapture.” Recapture is the landlord’s right to take back the premises and terminate the lease after the tenant goes dark, allowing the landlord to lease the space to someone else.

Exclusivity

Exclusivity is the tenant’s right to be the sole operator of a particular business within the shopping center. This is important to tenants both big and small. Exclusive rights can be tricky, and landlords and tenants need to pay careful attention to the agreement to avoid traps. When negotiating the tenant’s right to an exclusive use, the landlord should agree not to lease space in the future to a tenant for that particular use, as opposed to a general warranty of exclusivity. This avoids the risk that an existing tenant will change its use, resulting in an unexpected and uncontrollable violation of a general exclusivity warranty. The landlord will also want to negotiate for the most narrowly defined exclusive use possible. For instance, rather than grant an exclusive right for the operation of a restaurant, the landlord would want to state that the exclusive right is limited to a certain category of food. Broad categories of exclusive rights

could overly and unintentionally restrict a landlord’s ability to lease space in the center. Finally, landlords should negotiate for the option to void an exclusive right if the tenant stops using the premises for the exclusive use. Tenants should negotiate for special remedies for a violation of their exclusive rights, including a period of reduced rent until the violation is corrected.

Cotenancy

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A typical cotenancy right would allow this tenant to terminate its lease if the anchor tenant stops operating. For landlords, cotenancy rights can be a minefield to navigate; one misstep can result in a domino effect of lost tenants. For example, assume that the anchor tenant of the shopping center has the right to go dark, and that the landlord made the mistake of not negotiating the right to recapture. Also assume that two other major tenants of the center have a cotenancy right, giving them the option to terminate if the anchor tenant ceases operations. Finally, assume that three smaller tenants have a cotenancy right, giving them the right to terminate if at least two major tenants cease operating. If the anchor tenant goes dark, the consequence could be the loss of all five leases. This landlord could have avoided this catastrophe if it had (1) negotiated the right to recapture the

anchor tenant’s space and (2) negotiated into the other leases a reasonable period of time in which to replace the anchor tenant before the cotenancy rights were triggered. Sophisticated landlords will also require the affected tenant to prove an actual loss of business before taking advantage of cotenancy rights.

Radius Restrictions

A radius restriction either (1) restricts a tenant from opening another store within a geographic area or (2) restricts a landlord from leasing space to a competing business in other centers owned by the landlord within a geographic area (like an extension of an exclusive right). A landlord should seek the protection of a radius restriction when the lease is based in part on the expectation of percentage rent. In this case, the landlord will want to make sure the tenant’s business is not spread across several locations within one market area, thereby driving all sales (and resulting percentage rents) to the landlord’s center. If a landlord is willing to give a radius restriction to a tenant, the landlord must consider the effect such a restriction could have on the landlord’s ability to sell its other property within the restricted geographic area. To avoid such a problem, the landlord should require that any property sold within the restricted area be released from the radius restriction.

Putting It All Together

Any one of these topics, taken by itself, is straightforward to understand. It’s the intersection of these issues that creates complexity. The interplay between them, and how one issue implicates another, reinforces the notion that retail centers are organic and that their leases must harmoniously fit together to achieve a successful project. **N**

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The information in this column is not intended as legal advice but to provide a general understanding of the issues. Readers with legal problems, including those whose questions are addressed here, should consult an attorney for advice on their particular circumstances.