

**LEASING 101: UNMASKING THE HIDDEN
PITFALLS OF THE RETAIL STORE LEASE**

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The grand opening of a new store should be an exciting occasion, celebrating the hard effort and substantial time and money invested by the entrepreneur-owner to get the business up and running. How sad an occasion it would be if, on the day of the store's opening for business, a heavy rainstorm occurred, the roof of the building leaked water onto the racks and cases of merchandise displayed for sale to the public, and the landlord was unable or unwilling to mend the roof in a timely fashion. Whether or not the tenant would have any meaningful recourse against the landlord for failing to adequately maintain and repair a store building could be a function of whether or not the tenant negotiated a lease containing meaningful tenant remedies and recourse against the landlord for situations such as that described above.

It sounds like a real estate owner's fantasy: entering into a long-term commercial lease at exorbitant rents with a neophyte entrepreneur opening a new business. This might seem like a scenario which a landlord would relish because the deal should be quick and easy due to the future business owner likely possessing little leverage and minimal knowledge about the basics of negotiating a lease document. In truth, however, the landlord and the tenant are likely to be better served when a prospective tenant is versed not only in how to operate its business, but also some rudimentary understanding of the lease and the economic reality of operating the business under the customary form of retail lease frequently referred to as a "triple net lease." Opening a new store may be the entrepreneur-owner's largest business undertaking of her or his life and requires a major investment of both time and money. As such, the tenant should consider negotiating with the landlord with an eye toward obtaining some concessions clarifying the parties' obligations and rights. An important consideration to protecting and fostering the successful business is the tenant's ability to negotiate a lease document accurately and fairly memorializing the parties' understanding of the "deal," from both a business and legal perspective.

Two parties entering into a lease for space may believe that their business relationship as landlord and tenant will last many years. However, due to various uncertainties on both a personal and business level, the landlord or the tenant may want or need to end the relationship early. Several of the reasons for terminating the landlord-tenant relationship early are: (1) the landlord's desire to cash-out and terminate the lease to permit maximum profit upon the sale of the property, and (2) the tenant's desire to close and/or sell the retail business due to reasons such as health, family or other important issues that have developed and were not anticipated when the lease was first signed. As a result, it is best for the tenant to negotiate some downside protection and possible lease escape provisions before executing the lease so as not to have to rely upon the landlord for possible concessions after the lease is signed. It is also at the beginning of the parties' relationship that the tenant likely has the most leverage to negotiate any meaningful lease concessions from the landlord.

Recently I had the opportunity to represent two women owned retail businesses, both of which opened for business in grocery-anchored suburban shopping centers. These woman entrepreneurs have learned much about the complex nature of a shopping center lease and the importance of extensively negotiating the lease document before signing on the proverbial dotted line.

Earlier this year The Little Gym opened in Olney, Maryland. The Little Gym is a national company with several hundred locations across the country, providing a varied array of fitness classes and the like to children up to the age of 12. In Olney, Andrea Brody operates The Little Gym. In working through the process of negotiating the lease, one of her most challenging

issues was ironing out the details of both the landlord's and tenant's construction obligations and specifically which party was providing and/or paying for restoring and upgrading the heating, ventilating and air conditioning (HVAC) system to good working order and condition.

Paula's Boutique, a successful woman operated business in Olney, Maryland recently opened its second location in Potomac, Maryland. Two of the major challenges confronting the owner, Paula Kahla, involved the landlord's and tenant's respective construction obligations, and the relative lack of drawing power of the shopping center's largest tenant. From the beginning of the lease negotiations the tenant expressed her concern with whether her business would be harmed if the largest tenant failed to attract sufficient business to the shopping center. As a result, the tenant and landlord explored and discussed the landlord's vision for the center and the parties attempted to understand and in a reasonable manner deal with each other's concerns.

As both of the above-mentioned businesses will attest, achieving the tenant's business goals was better accomplished by the use of a Letter of Intent as a preliminary step in lease negotiations. Parties considering entering into a commercial lease often negotiate and enter into a Letters of Intent to determine whether a deal can be successfully concluded before expending much time and money wading through the complex lease document. Also, the Letter of Intent can be invaluable from a tenant's perspective, as it can accomplish critical elements of the deal in advance of the lawyers getting involved. Depending on the parties' intent and desire, the Letter of Intent can be binding, although more often it is merely a preliminary expression of desire as to what certain elements of a deal would include, and not a binding agreement.

There are varied reasons and objectives parties frequently have when using a Letter of Intent, which include some or all of the following:

- Confirming some or all of the critical terms of a deal.
- Binding the parties to an actual, enforceable contract.
- Tying up or removing from the market the desired space while negotiations proceed so that the landlord cannot solicit a lease from others while good faith negotiations are proceeding.
- Ascertaining whether or not the deal is one likely to be concluded.
- Obtaining financing or approvals at an early stage.
- Satisfying conditions specified under partnership agreements or financing commitments.
- Preventing the tenant from leasing space in another location in competition with the space under negotiation by the parties.
- Providing for certain remedies should the negotiation fail, e.g., reimbursement of particular costs and expenses such as architects, engineers and attorneys fees.
- Entering into mutual confidentiality agreements regarding the intended transaction.
- Reducing time and expense by providing the parties and their lawyers with a guide for the preparation of the lease document.

Letters of Intent often do not cover all of the terms of the proposed lease transaction. Nevertheless, landlords and tenants sometimes use fully binding Letters of Intent or provide for particular binding provisions in a non-binding Letter of Intent. Examples of binding provisions in non-binding Letters of Intent include confidentiality covenants and agreements to remove the property from the market, and exclusively negotiate with one party for a defined period of time. The primary function of using the Letter of Intent for many is to smooth the way to an easier and quicker negotiation, with the Letter of Intent serving as the guide or road map for critical business issues.

Once the Letter of Intent is completed the landlord and tenant move to phase II of the lease negotiations, the lease. Some of the major economic components of a lease are discussed below.

Minimum Rent. This is the main component of rent and is sometime referred to as base rent. It is usually based upon the total leasable square footage of the leased premises. In several of the most expensive submarkets within the Washington, DC metropolitan area, the minimum rents for 2004 at some of the most prominent retail fashion oriented properties are expected to exceed \$100.00 per square foot. In some of the outlying market areas, however, minimum rent for conventional neighborhood food/drug retail properties is in the \$20.00 to \$30.00 per square foot range. Minimum rent seldom stays fixed over the entire term of the lease. Typically it increases according to one of several methods such as a pre-determined stepped schedule, the Consumer Price Index (CPI) or the fair market rental value approach.

Additional Rent. In addition to the minimum rent, landlords charge tenants for so-called additional rent when the tenant is entering a triple net lease. The triple net lease is the favored lease format for retail properties in this area and the tenant will pay, as additional rent, a pro-rata share of most if not all of the costs and expenses incurred by the landlord for operating, owning and managing the shopping center or other property of which the tenant's store premises form a part. These charges include insurance costs, property taxes and operating expenses for maintenance and repair of the property. The extent of the net charges are frequently not fully appreciated by the tenant and should be carefully reviewed and understood prior to lease execution. The charges may also include landlord management fees, administrative fees, marketing and advertising, legal expenses, capital expenditures, reserves and others too numerous to mention. In some jurisdictions the landlord is required to permit the tenant an audit right, however, reserving this right in the lease is still the preferred approach. Additional considerations are whether or not the landlord will consider capping certain categories of expenses (e.g., controllable costs) and excluding certain categories of costs and expenses that arguably should be paid by the landlord and not charged to the tenant.

Percentage Rent. Retail shopping center leases often provide for percentage rent payments in addition to the minimum rent and additional rents. Percentage rent payments are an additional rental assessed against the tenant based upon a percentage of the sales of goods and/or services made by the tenant within the store premises. The amount is calculated by determining a "break point" or dollar amount of sales out of the store premises per year, above which a specified percentage rent is payable. The tenant is required to maintain accurate books and records of its accounts, provide the landlord periodic statements of sales, and pay the applicable percentage rent monthly, quarterly and/or annually. The landlord will undoubtedly request the right to audit tenant's sales records. Various exclusions should be negotiated and the landlord should agree to retain tenant's sales information in confidence.

Condition of Premises/Construction Allowance. Tenant's construction work is, in part, based upon the existing condition of the premises when possession is made available to the tenant. More often than not the premises are delivered to the tenant in "as-is" condition and all of the work required to ready the premises for business is to be completed by the tenant. Depending upon the tenant's leverage, the landlord may provide a tenant construction allowance in the form of a cash payment stated as a dollar amount per square foot. Before the Lease is signed, the tenant should conduct a thorough inspection of the premises with a qualified contractor to determine its condition and suitability, including the condition of the HVAC and other systems. Another important consideration for the tenant is obtaining permission to build out and fixture the premises without undue restriction or controls by the landlord. This can best be accomplished by obtaining landlord's approval of tenant's construction, and sign plans in advance of executing the Lease.

Security Deposit. Except for tenants with a very strong financial statement and proven track record for successfully operating a similar business, the landlord typically requires a cash security deposit equal to one month's rent and additional charges. Without a security deposit, a landlord may have little recourse if a tenant vacates and abandons its premises before the lease term ends.

Term. Generally, the landlord may prefer a longer lease term than the tenant. Shopping center leases usually run for at least five years. The tenant should also negotiate an option to renew or extend the lease term as part of the original lease at predetermined rents. The Lease should provide that the term commences and the tenant begins paying the rent and other charges upon the tenant's opening for business, or within an agreed upon number of days (e.g., 60-days) after the tenant obtains sole and exclusive possession of the premises.

Option to Terminate. If a shopping center's anchor tenant was to close during the lease term the impact could be devastating upon the tenant's business. The tenant would do well to negotiate a right of early termination available should its business not succeed in spite of commercially reasonable efforts or if a substantial number of other stores or the anchor tenant(s) vacate the shopping center resulting in an adverse affect upon the tenant's ongoing business.

Exclusive Use. The tenant should seek an exclusive use provision requiring that the landlord not lease to any other business whose use competes with the tenant's use. This provision is very important to most tenants because it will minimize the chance that the tenant's business will be harmed by direct competition from another merchant in the shopping center.

Radius Restriction. The flip side of the tenant's exclusive use right is that the landlord may require that the tenant and/or its officers, directors and others with an interest in the tenant's business refrain from operating any competing or similar business within a set distance of the shopping center (e.g., three miles). The stated justification for this form of restriction is to require that the tenant focus all of its efforts on the business operated at the premises rather than another location potentially in competition with the business operated at the premises.

Operating Covenant. Most shopping center leases will require the tenant to operate during all days (except a few notable national holidays) of the year and for at least twelve hours a day plus any additional days and hours designated by the landlord. This requirement is especially prevalent in a lease where the tenant is required to pay percentage rent. The tenant would do well to negotiate in the lease some flexibility to permit it to close periodically for reasons such as inventory, remodel, etc., as well as some other limited exceptions to the operating covenant.

Tenant's Default. Many shopping center leases provide for an automatic default upon the tenant's failing to pay rent or any other charges when due. The tenant should be extremely hesitant to agree to any lease where the lease does not provide that the landlord must first give written notice to the tenant specifying the default and providing the tenant with a reasonable period to cure the alleged default before the landlord can hold the tenant in default of the lease.

Assignment and Subletting. Most shopping center leases provide that the landlord has the sole and absolute unfettered right to determine whether or not to permit an assignment of the lease or sublet of the premises. The tenant's future personal and business objectives, however, may be frustrated if the tenant has no ability to sell its business. The tenant would be better served if the lease required that the tenant first seek the landlord's consent but that the landlord's consent could not be unreasonably withheld or delayed. Typical criteria important to a landlord's decision to consent or deny consent to a proposed assignment or sublet include the intended use of the premises, the financial strength of the new owner, and the business track

record of the new owner. The lease should also clearly define what constitutes an assignment, including whether or not a change in the ownership structure will be deemed to be an assignment requiring the landlord's permission.

Maintenance/Repairs. The shopping center lease will likely provide that the landlord has little or no obligation with respect to needed repairs involving the store premises. Customarily, the landlord should be required to maintain the roof and structural components of the premises, including the utility lines leading to the point of connection to the premises. It is also important to specify whether landlord repairs are at the landlord's sole expense, or whether they are paid for by the landlord and then billed to the tenant as a portion of the tenant's pro rata share of additional rent charges discussed above. Another important item is the HVAC system serving the premises, as it is a very costly obligation for the tenant if it is required to replace the air conditioning unit due to its obsolescence. The tenant should seek at least a one-year HVAC warranty from the landlord.

Conclusion. In conclusion, the commercial lease agreement is a highly technical document generally one-sided, and often favoring the landlord. It may contain as many as 50 pages of legal sized text plus additional exhibits and addenda, and is stocked with typically landlord oriented "boilerplate" provisions. The lease document, if not modified, may be quite onerous, intrusive and patently unfair to the unsuspecting tenant. The lease serves as a contract, which will govern the landlord-tenant relationship for the life of the lease term. The typical shopping center lease term will often be at least a decade, containing an initial lease term of five years with possibly another successive five year option term. For these reasons, tenants should not be reluctant to consult an attorney for lease review and negotiation. It is useful, if problems arise during the lease term, to have had legal counsel review the lease to anticipate and protect the tenant's interests.

About the Author: Marc E. Rosendorf is an attorney in Olney, Maryland. He is a member of numerous state Bar Associations and the International Council of Shopping Centers for whom he has served as Maryland & Virginia State Government Relations Chairman and in various other leadership capacities. Mr. Rosendorf's articles have been published by the American Bar Association and the International Council of Shopping Centers and he has lectured extensively. Prior to opening his own business, he was the Corporate Counsel for a national retailer and the Senior Counsel for a prominent real estate developer. Mr. Rosendorf provides legal services and real estate advisory and consulting services to local, regional and national retailers and other businesses. He is a graduate of the University of Maryland at College Park and the Catholic University of America School of Law. He may be reached at (240) 423-0094 or you can find me at www.rosendorflaw.com.