

When Office Building Landlords Lease To Retail Tenants

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When an office landlord deals with a retail tenant, they may both find that it's not business as usual.

EVEN IF IT IS JUST A DELI OR NEWSSTAND, many office buildings have at least some retail space. Since the amount of office space in mixed-use buildings usually far exceeds that of the retail space, landlords of mixed-use buildings rarely bother developing a retail lease form. Instead, they often just take their form office lease and insert retail provisions (band-aids). This ad hoc approach often leads to an awkward blend of conflicting office and retail leasing concepts.

This article compares retail leases to office leases, and presents a checklist of issues to help you spot key lease issues not usually dealt with in office leases. This way, if you do use an office lease as the template for drafting the occasional retail lease in a mixed-use building, you will not inadvertently omit key provisions. Certain retail uses do, however, require documents tailored to the specific tenant. For example, if the tenant is a restaurant, the author recommends that you use a true retail lease specifically designed for a restaurant lease.

ADDITIONAL TENANT OBLIGATIONS• One major difference between office and retail leases are the level of services the retail tenant receives. The retail landlord provides only limited or no utilities (perhaps only water), and frequently provides no ventilation, no janitorial services, no elevator access, and perhaps even no guaranty of lobby access, if the leased space has a separate entrance. Similarly, the landlord frequently does not maintain, insure, or restore a retail tenant's build-out. In contrast, landlords often install, insure, and restore an office tenant's leasehold improvements.

ECONOMIC TERMS• Unlike office tenants, retail tenants must often pay the landlord a percentage of gross sales as additional rent (percentage rent) in addition to fixed or basic rent. Percentage rent clauses usually require an agreement on the "breakpoint" and inclusions and exclusions from gross sales. A breakpoint is a dollar amount representing a target figure for the tenant's annual gross sales from the premises. The tenant must pay percentage rent on the portion of total gross sales that exceed the breakpoint. Customary exclusions from gross sales include lottery ticket sales, internet sales, merchandise returns, and the like.

Sales Statements

Percentage rent provisions often require the tenant to provide monthly, quarterly, or annual sales statements. They often allow the landlord to audit those statements and impose penalties on the tenant for failure to provide the required statements.

Termination Rights Tied To Gross Sales

Likewise, unique termination rights tied to the tenant's gross sales (e.g., "kick-out" clauses) may come into play. A kick-out clause allows the landlord to kick the tenant out if its gross sales fall below a specified annual target. The tenant may negotiate for a provision allowing it to terminate the lease if its gross sales do not meet the tenant's expectations. If you have not dealt with these issues when drafting the letter of intent, you may want to consider them when you start to actually draft the lease.

Expense Pass-Throughs

In addition to differences in base rent, retail leases also treat operating expense pass-throughs differently from office leases. In most office leases, tenants pay their share of operating expenses only if those expenses exceed a base year or expense stop. In contrast, retail leases are typically triple-net. Can the landlord's accounting system switch-gears and prepare statements appropriate for the retail lease?

A lease using a "base year" means the tenant pays its share of operating expenses to the extent they exceed (on a per square foot basis) the operating expenses, taxes, and insurance that the landlord incurred during the first year of the tenant's term. A base year lease includes the landlord's estimate of the first year's charges as a component in base rent (or the actual charges, if the lease is entered into after the base year charges are ascertained). Similarly, a lease using an "expense stop" means the tenant pays its share of operating expenses, taxes and insurance to the extent they exceed a stated dollar amount per square foot.

The term triple net has no one accepted meaning. Typically, however, it means the retail tenant pays the tenant's share of taxes, maintenance, and insurance, in addition to base rent (i.e., base rent is net of these three items--triple net). Under a triple net lease, during each year of the term the tenant pays its share of taxes, maintenance, and insurance incurred in each such year, without reducing the tenant's share by the amount of such charges incurred in the base year. Similarly, no limitation by way of an expense stop applies.

Regardless of whether the lease is base year or triple-net, retail tenants often object to paying the same operating expense pass-throughs that office tenants pay, since retail tenants typically receive far fewer services.

Operating Expenses Solely Benefiting Office Space

In projects with both office and retail components, expenses relating solely to the office portions of the building are typically not passed-through to retail tenants. Some of the charges typically not passed-through for this reason include janitorial services and utilities provided for tenanted office space, elevator maintenance expenses, and building lobby security.

Operating Expenses Solely Benefiting Retail Space

In a mixed-use project, the landlord may incur certain operating expenses that are properly payable only by the project's retail tenants. For example, in a project containing a food court, the landlord may perform janitorial services relating solely to the food court area. The landlord would then properly allocate these expenses based on the total square footage of the food court tenants in the building.

Operating Expenses Benefiting All Tenanted Space

With respect to operating expenses incurred for services that benefit both office and retail tenants of a project, the retail tenant will likely agree to pay only to the portion of the charge representing the benefit the retail tenant receives. In the case of utility charges (assuming the retail space is separately metered), the landlord would pass through to retail tenants only the portion of utility charges incurred in connection with the ground floor and exterior portions of the project, and exclude utility charges relating to the office floors. In the case of janitorial services, the landlord would pass through to retail tenants only the portion of such charges incurred for the building lobby, and exclude janitorial charges relating to the office space. In some cases the landlord will have to reasonably estimate and allocate such charges between the office and retail space in the project.

CONSTRUCTION• Many construction issues are driven by the tenant's specific type of retail operation. At a minimum, however, a landlord leasing to a retail tenant should bear in mind that retail tenants typically control, and are responsible for, their own build-out. One reason is because retail tenants who are part of a national or regional chain typically have established contractor relationships, as well as standardized store designs, finishes and millwork. Having the tenant responsible for construction also benefits the landlord. The landlord may want the tenant to be responsible for Americans with Disabilities Act ("ADA") compliance issues, as well as fire and life-safety concerns (especially so with restaurant tenants). Finally, a significant construction issue concerns the exterior façade and the retail tenant's signage requirements. The landlord should be sure it is comfortable with the retail tenant's typical trade dress and signage designs. Alternatively, if the project is subject to any restrictions that affect the project's interior (e.g., a limitation on sign size, color, etc.), the landlord should make sure that the tenant is aware of such requirements early-on in the leasing process.

MAINTENANCE AND JANITORIAL• Landlords typically require their retail tenants to maintain their own premises since so much of a retail tenant's build-out is not "building standard." This would include the heating ventilating and air conditioning ("HVAC") system, which for retail space is usually not part of the base building's system. In addition to addressing ordinary maintenance issues, a retail lease should address waste removal, pest and vermin extermination, as well as odors and noises coming from the retail space. As discussed, typically retail tenants are solely responsible for cleaning their premises, as well as removing waste.

UTILITIES• Retail tenants typically obtain utilities directly from the service provider. If direct metering is not possible, the landlord may wish to install a sub-meter or check-meter in order to more equitably charge the retail tenant for its utility use. Restaurant tenants typically use a disproportionately large amount of water, so this may also be a concern for the landlord.

OPERATIONS• Unlike office leases, retail leases typically have provisions governing the day-to-day operations of the tenant's business. This is partially because retail leases often have a percentage rent provision and landlords therefore want the tenant to maximize its sales.

Similarly, since retail tenants interact with the public and operate on the ground floor of the building, the landlord will be concerned about how retail tenants will affect the appearance and reputation of the building.

Some operational issues concern percentage rent. The landlord will want the retail tenant to operate its business during certain minimum hours and continuously operate its business throughout the year. Tenants typically negotiate for the right to cease operations for certain reasons such as force majeure events, or closures for periodic taking of inventory and remodeling. The landlord may also require that the tenant:

- Maintain adequate stock;
- Employ trained sales staff;
- Light the display windows, have current, professional displays; and
- Generally operate the premises to the highest standards (e.g., no clearance sales).

Storage is a related issue. Storage space comes at the expense of sales space. Less sales space usually means less sales, which in turn means less percentage rent for the landlord.

Many of these issues are important even if the landlord does not receive percentage rent.

Other retail operational concepts include limitations on the use of the sidewalks and areas outside of the premises, prohibitions on playing music and televisions, and a requirement that the tenant provide security. In part because retail tenants control their own build-out, landlords typically require the tenants to fully insure their improvements against damage and require them to promptly restore the same following a casualty. Delays in a retail tenant's restoration following a casualty may leave the landlord with a dark store and no percentage rent.

FOOD TENANTS • Tenants that sell food for on or off-premises consumption bring a special set of issues, these include:

- Pest inspections;
- Odors and noises,
- Trash removal (wet and/or dry); and
- Special maintenance concerns (e.g., grease traps, exhaust systems, and waste-lines).

Lastly, if the tenant serves or sells liquor, the tenant should be required to carry dram shop insurance and to obtain and maintain all applicable licenses.

OTHER ISSUES• Office leases all address the tenant's permitted use, assignment rights, and signage rights. These issues, however, take on an even greater significance in a retail setting. A retail tenant's permitted use is often narrowly drafted, particularly if there are multiple retail tenants, so that each retail tenant can successfully operate its business and the total gross sales from the retail area of the project can be maximized. In office leases, the landlord customarily agrees not to unreasonably withhold its consent if the tenant desires to assign the lease. In a retail lease, however, landlords typically prohibit the tenant from assigning the lease, since the landlord typically likes to establish a particular tenant mix. Another reason for such prohibition may be that the landlord may feel that the owner of the retail business may have a significant connection with its operations, and a successor may not run the business as well (thereby lowering percentage rent, and possibly jeopardizing the tenant's ability to pay base rent). Signage concerns may also arise. An office tenant requires directory and suite entry signage, but only the largest office tenants have visible exterior signs. A retail tenant, in contrast, typically does not need directory or suite entry signage, but will have highly visible exterior signage.

GENERAL RETAIL ISSUES • In addition to the issues noted above, the landlord of a mixed-use project may come across several concepts unique to retail leasing. A full description of those provisions is beyond the scope of this article, but a brief description of some key provisions is provided below.

Exclusive Use Provisions

An exclusive use clause gives the tenant the exclusive right to sell certain products or services. Usually, the exclusive right is limited to the tenant's main line of business, even though the tenant's permitted use may be much broader. Depending on what products or services the tenant wants the exclusive right to sell, a landlord may view the request as an easy concession or a difficult constraint. One reason exclusive use provisions are difficult for landlords is that retail tenants also typically request broad use clauses allowing the right to sell a broad range of products on an incidental basis. The combination is problematic, and a landlord will have to carefully consider the terms of any exclusive granted, as well as what competing uses or key tenants should be carved-out from the exclusive.

Radius Restrictions

Under a radius restriction, the tenant cannot open a store within a certain radius of the premises. When a tenant pays percentage rent, a radius restriction will prevent that tenant from opening a new store nearby location (e.g., within a one-mile radius) and possibly diminishing gross sales from the original store. National tenants strongly oppose such restrictions, in part because it impairs a corporate tenant from purchasing or otherwise merging with competitors that have locations within the radius restriction.

Co-Tenancies

A co-tenancy provision gives the tenant certain rights if another tenant in the project is not operating. An “opening co-tenancy” provides that a tenant has no obligation to open for business and/or start paying rent until the other tenant (usually an anchor store) is opening and operating. An “ongoing co-tenancy” provides that a tenant may reduce (or fully abate) rent and/or terminate if the co-tenant (who has ceased operations) is not replaced with a comparable tenant within a specified period. In office projects with little retail space co-tenancy issues rarely arise.

CONCLUSION• The issues discussed above and on the attached checklist are not exhaustive (and hopefully not exhausting), but should help an office landlord think through the unique concerns that arise in retail leasing in an office building.