Store Lease Pitfalls – Part 1. By William Walzer.

The quality of a retail tenant's lease is perhaps the most central factor in the store's success. This is especially true in the metropolitan New York area, where rent accounts for a greater percentage of overhead than it does elsewhere. A good lease allows the tenant to adapt to changing events and tastes. It allows the tenant to profit from the skill and efforts of its principals. A bad lease stifles innovation, transfers the landlord's ordinary business risks to the tenant, and enables the landlord to impose conditions for permitting ordinary changes in the tenant's operations.

Despite the importance of lease language, local tenants, in contrast to national retailers, often expend little effort in negotiating improvements to the terms initially drafted by the landlord. Negotiations vary according to the situation, but the following issues should always be considered:

- Term and Options. The benefits of the careful selection of a store's location can be wiped out if the business doesn't have a term long enough to establish itself or justify the initial expense of its opening. Too long a lease term can result in a venture's being stuck in an unprofitable location. The drawbacks of a short lease term can be ameliorated by options to renew on the part of the tenant. The risks associated with too long a term can be minimized with the use of single purpose tenant entities, reasonable security deposits, tenant options to terminate and principals' guarantees that limit liability.

- Personal Guarantees. Generally required for all but the most credit worthy tenants, individual guarantees of leases are typically primary obligations of all tenant obligations, allowing the landlord to pursue the guarantor without first seeking collection from the tenant. A guarantor may be able to negotiate durational limits or monetary caps on liability. Presently in vogue are "good guy" guarantees, the logic of which is to prevent the guarantor who controls the tenant from taking advantage of the frequently long eviction process. Liability under the guaranty ceases for rent arising after the surrender of possession of the premises. Yet we see many "good guy" guarantees drafted in an expansive manner, resulting in liability exceeding the commonly understood limitation.

- Assignments and Subletting. The principals of a successful retail venture deserve the ability to profit from their success by selling their business along with the remaining term of its lease. Yet landlords will inevitably restrict assignment and subletting in a transparent effort to share in the payday enjoyed by their tenants upon a transfer. If, on the other hand, the location has proven unsuccessful, restrictive transfer clauses inhibit the ability of the tenant to reduce its losses when merely "walking" on the lease is not possible because of general firm exposure, unlimited personal guarantees or large securities. A covenant on the part of the landlord not to unreasonably withhold its consent to a transfer request is a common compromise, but not a completely comfortable one for the tenant, as arbitrary standards such as the capitalization or experience of the proposed transferee may give the landlord the pretext to stop a deal. The "no unreasonable withholding covenant" is particularly unsatisfying when coupled with the common clause, usually found many pages later, that the landlord may not be held liable for being unreasonable. The best outcome for the tenant is one that allows assignment and subletting without landlord approval when certain pre-determined conditions have been met.

- Use Clause/Exclusivity Issues. A changing business environment militates for a broad use clause, allowing a tenant to change the store's focus. Yet landlords typically draft use clauses within the narrow parameters of the tenant's original business plan. The restrictive use clause may enable the landlord to arbitrarily stop the assignment of the lease or a subletting of the store simply by enforcing the restriction, even where the landlord has promised not to unreasonably stop such a transaction. There is no justification for a restrictive use clause for a storefront. In a retail center however, the appropriate tenant mix and the demands of larger tenants for exclusivity in their primary business lines are appropriate landlord concerns. While a restrictive use clause may therefore be justified in a center, the natural quid pro quo is the tenant's protection from direct competitors in the center by an appropriate landlord covenant.

- Common Area Maintenance. In a never-ending quest to receive their rents net of every possible business risk, retail center landlords always include a proportionate pass-through to the tenants of the costs of maintaining the center. The problem we typically see is that landlords are not content merely to recoup their costs: they angle to make the CAM clause a profit center by including within its reach management fees, on-site supervision, office overhead (regardless of the number of properties served by the office), and the cost of replacing center components properly classified as capital expenses rather than operating costs.

This article will be continued in our next newsletter.