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Tug of War

Devising leasing clauses to balance the landlord-to-tenant relationship.

by Jerry Siegelman

Tenants under retail leases often have negotiated termination rights based on certain conditions in the lease, for example, co-tenancy failures or violations of use restrictions. What is sometimes forgotten when drafting these provisions is the recapture of the landlord's cash outlays at lease inception, whether for tenant improvement allowances, broker commissions, or other similar payments.

While it is tempting to include the cost of landlord's work to prepare the leased premises for the tenant's occupancy, the tenant would argue that these improvements will benefit the next tenant and the costs should not be recaptured by landlord.

Many shopping center retail leases contain co-tenancy clauses that are conditional on the tenant's opening or continuous operation based on the landlord achieving certain leasing thresholds in the shopping center. These clauses may contain a minimum number of anchor tenants and list a certain percentage of the floor area of the other stores that is either leased or open, depending on the state of the center.

Preventing Risks

While an article can be written on these clauses alone, most clauses provide that if the condition is not satisfied, the tenant does not have to open or does not have to operate. If the tenant chooses to open and operate, however, the tenant has the right to pay a reduced rent for a period of time until the condition is cured.

If the condition is not cured within a specified time, for example 12 months, the tenant has the right to terminate the lease.

If that occurs, the landlord's counsel should be mindful to provide provisions in the lease for recapturing the landlord's cash outlays at lease inception, such as tenant allowances, incentives, and brokerage commissions.

Tenants will try to limit the reimbursement to the landlord to the then unamortized amount of these outlays. This would be done by dividing the difference between an asset's cost and its expected salvage value by the number of years it is expected to be used during the initial term of the lease.

Tenants often have similar rights when it comes to violations of the tenant exclusives negotiated in the leases. However, the argument for the landlord's ability to recapture the cash in those cases is not as strong.

Recapturing Cash

In the case of a co-tenancy failure, the landlord is not fully in control of the occupancy levels at the shopping center. Bankruptcies, tenant closures, and recessions are all circumstances outside of the landlord's control. In the case of violations of the tenant exclusive, however, the tenant's argument is that this is a circumstance within the landlord's control. If the landlord fails to meet its obligations, the tenant should receive compensation.

The landlord's counsel should maintain that the provision should allow recapture in the case of a rogue tenant. That is a tenant that is operating contrary to the tenant exclusive and contrary to the provisions of its own lease. However, the tenant could still argue that it is still within the landlord's control to pursue the rogue tenant, including resorting to litigation if necessary.

In the case of landlord's remedies for a tenant default, the argument for recapturing the cash becomes more difficult. If the rent is accelerated or collected each month for the remainder of the lease term, the tenant's position is that the cash outlays are built into the fixed rent at lease inception. If the landlord is being paid its rent, it is recapturing the cash.

It behooves landlord's counsel to carefully review the lease during its negotiation for tenant termination rights and determine under what circumstances the landlord should be compensated for its cash outlays.

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