KEY ISSUES IN RETAIL AND OFFICE LEASES

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TABLE OF CONTENTS
KEY ISSUES IN RETAIL AND OFFICE LEASES

TABLE OF CONTENTS
(continued)

Page

COMMON DIFFERENCES BETWEEN RETAIL AND OFFICE LEASES

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I. INTRODUCTION

A. Scope of Article. This article is intended to provide a summary and analysis of some of the common differences between retail and office leases. Although these leases serve the same purpose – the purchase by the tenant of the right to use real property, the tenant's intended use and the differences between office space and retail space lead to very different issues and very different documents.

Unlike office leasing where specific location is often a secondary consideration to general geographic preferences, rental rates and space needs, retail leasing is often primarily concerned with location. For example, an office tenant who wants to lease 20,000 square feet of office space in the central business district of a major city often has numerous options. On the other hand, a retail tenant who wants to be on a corner tract at a very busy (or soon to be very busy) intersection can have, at most, four options and often has as few as one. Similarly, an office landlord is normally more concerned with the balance sheet of a prospective tenant, as opposed to the traffic patterns likely to be generated by such tenant. A retail landlord cares very much about the tenant's balance sheet, but it also cares about the type of business the tenant conducts and the traffic such tenant can bring to the retail center. Retail space is not only valued in terms of its overall location but also for its visibility, accessibility and its proximity to desirable traffic patterns and other retail operations. The interdependence between retailers is a major element of the development, leasing and operation of a retail center. Conversely, tenants in an office building do not generally rely on each other to attract customers. Similarly, retail landlords must be cognizant of the market place in which their tenants compete in order to create an environment where the tenant will benefit the retail center, be successful and, therefore, able to pay the rent.

II. EXECUTIVE SUMMARY: WHAT MATTERS MOST TO THE PARTIES.

Other than rent, which is a key issue in all leases, what do landlords and tenants care the most about with respect to their leases? Here is a summary of the issues to consider:

A. Retail Leases.

1. Rent commencement date.

2. Exclusivity and use clauses.

3. Restrictions on certain uses.

4. Visibility (line of sight, elevations, etc.).

5. Access and parking.

6. Operating covenants (or the right to go dark).

7. Care and maintenance of common areas.

8. Signage.

B. **<u>Office Leases</u>.**

1. Operating Expenses (base year, expense stop, etc.).

2. Renewal and preferential rights.

3. Landlord's services.

4. Base building improvements

5. Telecommunications, rooftop use, etc.

III. USE CLAUSES, EXCLUSIVITY CLAUSES, OPERATIONS CLAUSES, AND ANCHOR TENANT CLAUSES.

A. **Avoiding Disaster**. Counsel involved in any type of lease negotiation or representation must understand the purpose, content and effect of any use clauses, exclusivity clauses, operations clauses and anchor tenant clauses contained in the lease. Extreme caution should be used in both negotiating and drafting such clauses to ensure that each clause is consistent with the others and that the clauses, taken as a whole, correctly apply to the type of premises being leased so that they correctly meet the client's needs. Failure to ensure consistency among these clauses can result in disastrous consequences for both parties.

B. **Use Clauses**. A use clause is a provision contained in the lease pursuant to which the landlord and the tenant agree on the purposes for which the tenant can use the premises. The use clause can be open ended, such that the tenant may use the leased premises for "any lawful purpose," or the use clause may be specific, such that the tenant may only use the leased premises for one or more specific operations, such as a supermarket or drugstore. It is important to note that the typical use clause simply sets forth the permitted uses for the leases premises but does not constitute an affirmative obligation on the part of the tenant to actually commence and maintain such operations in the leased premises.

In addition to setting forth the permitted uses for the leased premises, the use clause may also contain a list or description of prohibited uses which may not occur in the leased premises. As will be discussed later, it is essential that prohibited uses be contained in all other leases after an exclusivity provision has been granted to a particular tenant for a particular use.

1. **Retail**. Use clauses are one of the foundational provisions used by landlords in promoting the overall financial success of retail projects by maintaining the proper "mix" of tenants. Maintaining an appropriate mix of tenants has several beneficial elements. A good mix helps the entire project to maximize traffic flow. Consequently, tenants stay longer, are willing to pay more in base rental, and the landlord has the opportunity to share in the financial success of each tenant through the payment of percentage rent (discussed in more detail later). Often, use clauses are utilized when a landlord has already granted another tenant an "exclusive" right to run a particular type of business within the project. Use clauses can also be a powerful means of preserving the integrity of the project and preventing undesirable businesses from operating on the premises.

2. **Office**. In office leases, often use clauses are generally used merely to prevent tenants from using the premises in a manner that will damage the building, require too many building services, annoy other tenants, or cause a decrease in the value of the property. Unlike retail leasing, where the financial success of one tenant may be largely dependent on the other tenants in the project, office tenants tend to operate more independently from one another. Thus, use clauses in office leases tend to be more generic in nature. Many office leases merely state that the premises may be used for "office use."

3. **Practice Pointer**. Generally, use clauses in a lease will be view as permissive statements, not restrictive statements. Thus, it is important to state that the premises may be used for the stated purpose and "for no other purpose without the prior, written consent of the Landlord."

4. **Sample Use Clauses**.

Retail Use Clause

Tenant shall use the Leased Premises for the operation of a [DESCRIBE PERMITTED USE IN DETAIL] and for no other use or purpose without the prior written consent of Landlord, which prior written consent may be given or withheld in Landlord's sole and absolute discretion. Landlord and Tenant recognize, understand and agree that Landlord has entered into this Lease with the express understanding that Tenant shall use the Leased Premises at all times during the term of this Lease for the use and purpose permitted by this Section _____ and in a manner consistent with a first class shopping center. Landlord and Tenant further recognize, understand and agree that a breach by Tenant of the provisions of this Section ___ would result in irreparable harm to Landlord and that Landlord shall have the express right to seek an injunction or other equitable relief to prohibit Tenant from any breach or threatened breach of the provisions of this Section ___.

Office Use Clause

Tenant shall have the right to occupy and use the Premises solely for general business office purposes of a lawful nature and for no other use or purpose without the prior written consent of Landlord, which prior written consent may be given or withheld in Landlord's sole and absolute discretion.

C. **Exclusivity Clause**. An exclusivity clause is a provision contained in a lease pursuant to which the landlord grants the tenant the sole right to operate a particular type of business or operation within the project. As will be discussed later, the prior existence of one or more leases containing open-ended use clauses makes it difficult for the landlord to include an exclusivity clause in subsequent leases (at least without including an exception for the preexisting leases).

1. **Retail**. Exclusivity clauses are common in retail leases as they provide the tenant with an important guarantee against competition from competing businesses. Exclusivity clauses limited to the specific property in which tenant is leasing space generally do not present any extraordinary legal issues unless another tenant has been granted a broad use clause (as discussed more fully below). However, the issues surrounding exclusivity clauses may become evident when a project is multi-phased or encompasses a large development.

2. **Office**. Exclusivity clauses are far less common in the context of office leases, the exception being medical office buildings. Issues similar to those encountered in a retail setting may be present when an office building is part of a mixed use facility.

3. **Sample Exclusivity Clause**.

> During the term of this Lease and for so long and only so long as Tenant fully and timely complies with all of its obligations under this Lease, Landlord agrees to and shall refrain from entering into any new leases which permit, expressly or impliedly, the tenant thereunder to operate a business within the Project consisting of [DESCRIBE EXCLUSIVE USE IN DETAIL; ENSURE CONSISTENCY WITH USE PROVISION]; provided, however, that the exclusivity provisions of this Section _____ shall not apply to any leases within the Project existing on the date of this Lease or any renewals, extensions or replacements of such leases. TENANT RECOGNIZES, UNDERSTANDS AND AGREES THAT THE EXCLUSIVITY PROVISION OF THIS SECTION ____ IS EXPRESSLY CONDITIONED UPON THE FULL AND TIMELY PERFORMANCE BY TENANT OF ALL OF ITS OBLIGATIONS UNDER THIS LEASE, INCLUDING, WITHOUT LIMITATION, THE OPERATIONS COVENANTS CONTAINED IN SECTION ____ OF THIS LEASE. IN THE EVENT TENANT FAILS TO FULLY AND TIMELY PERFORM ITS OBLIGATIONS UNDER THIS LEASE, INCLUDING, WITHOUT LIMITATION, THE OPERATIONS COVENANTS CONTAINED IN SECTION ____ OF THIS LEASE, THE EXCLUSIVITY PROVISIONS OF THIS SECTION ____ SHALL AUTOMATICALLY AND IRREVOCABLY TERMINATE AND BE RENDERED OF NO FURTHER FORCE OR EFFECT; PROVIDED, HOWEVER, THAT IN SUCH EVENT, THE OTHER TERMS AND PROVISIONS OF THIS LEASE, INCLUDING, WITHOUT LIMITATION, THE OPERATIONS COVENANTS CONTAINED IN SECTION ____ OF THIS LEASE, SHALL REMAIN IN FULL FORCE AND EFFECT.

4. **Practice Pointer**. If the lease does not contain an operations covenant (discussed in more detail below), the exclusivity provision should expressly and automatically terminate if the tenant ceases operations in the premises. Otherwise, the

landlord would not be able to replace the tenant with another similar tenant (since that would violate the first tenant's exclusivity clause).

D. Operations Clause. An operations clause, often called a covenant to operate, is a provision contained in a lease pursuant to which the tenant agrees to keep its business open during specified days and hours. As will be discussed later, a carefully drafted operations clause is an essential part of any lease containing an exclusivity clause. Unfortunately, many major retail tenants will strongly resist operations clause, arguing that the determination whether to stay open is a business decision that should not be driven by a lease provision.

1. Retail. A well drafted operations clause helps ensure that the tenant will remain open and help draw traffic to the retail center. As more fully discussed below, a use clause is not a proper substitute for an operations clause and the ability of retail landlords to maintain property values may depend on appropriate use of these two clauses for multiple reasons. These reasons include: (a) vacant space may have a detrimental effect on the appearance of the project and may contribute to the deterioration of the property and reduction of rents; (b) vacant space may also contribute to the loss of other tenants (particularly if other tenants have anchor tenant clauses that may be invoked if an major tenant ceases to operate); and (c) vacant space may result in the overall decline in customer traffic, resulting in a reduction in percentage rent collected by a landlord from other tenants.

2. Office. Operations clauses are generally not as significant in office leases, since few office tenants rely on customer traffic to generate revenue. Rather, some office leases merely provide that it is a default for a tenant to vacate its premises. Many tenant will resist this, under the theory that the landlord is not damaged by the tenant's absence, as long as the tenant continues paying rent.

3. Sample Operations Clause.

(a) Tenant agrees to and shall conduct its business in the Leased Premises continuously on all days and at all hours during which the Project is generally open for business, including, without limitation, from ____ o'clock a.m. until ____ o'clock p.m. on all days, excepting only New Years Day, Easter Sunday, Christmas Day and such other times as the Leased Premises may be untenable by reason of damage by fire or other casualty.

(b) Tenant agrees to and shall keep the Leased Premises continuously and fully stocked with first quality, salable merchandise in a manner consistent with a first class shopping center.

(c) Tenant agrees to and shall maintain at all times a full, complete and competent staff of employees sufficient to operate its business in the Leased Premises in a first class manner.

(d) Tenant agrees to and shall use its best efforts to achieve a maximum sales volume in the Leased Premises, including, without limitation, expending reasonable sums for advertising and other promotion.

(e) Tenant agrees to and shall conduct its business in the Leased Premises under the name ____.

(f) Tenant agrees to and shall keep all display windows in the Leased Premises visible and lighted during such reasonable periods of time as may be required by Landlord.

(g) Tenant agrees to and shall use for office, clerical or other non-sales purpose only such minimum space in the Leased Premises as is reasonably required for the operation of Tenant's business therein and shall not perform any office, clerical or other non-sales function in the Leased Premises for any business operation other than the operation of Tenant's business in the Leased Premises.

(h) TENANT RECOGNIZES, UNDERSTANDS AND AGREES THAT THE EXCLUSIVITY PROVISION CONTAINED IN SECTION ____ OF THIS LEASE IS EXPRESSLY CONDITIONED UPON THE FULL AND TIMELY COMPLIANCE BY TENANT OF ALL OF ITS OBLIGATIONS UNDER THIS SECTION ____. IN THE EVENT TENANT FAILS TO FULLY AND TIMELY PERFORM ITS OBLIGATION UNDER THIS SECTION ____, TENANT'S EXCLUSIVITY RIGHTS UNDER SECTION ____ OF THIS LEASE SHALL AUTOMATICALLY AND IRREVOCABLY TERMINATE AND BE RENDERED OF NO FURTHER FORCE OR EFFECT; PROVIDED, HOWEVER, THAT, IN SUCH EVENT, THE OTHER TERMS AND PROVISIONS OF THIS LEASE, INCLUDING, WITHOUT LIMITATION, THE TERMS AND PROVISIONS OF THIS SECTION ____, SHALL REMAIN IN FULL FORCE AND EFFECT.

4. Practice Pointer. As mentioned, many major retailers will strongly resist an operations clause. Thus, this issue is often heavily negotiated. One compromise is to allow the landlord to terminate the lease if the tenant elects to go dark. Occasionally, the landlord will be required to reimburse the tenant for the unamortized cost of tenant improvements (perhaps including the cost of the tenant's building if the tenant paid the construction costs). In sum, this is an issue that is hotly debated in the industry, but one that must be addressed in the lease.

E. Anchor Tenant Clause. An anchor tenant clause is a provision contained in a lease pursuant to which the landlord induces a prospective tenant to lease the space in the retail center based on the landlord's covenant that the landlord is either has leased or will lease other space to another tenant, usually a supermarket, large department store or other business likely to attract a significant number of customers to the center. The rationale behind the anchor tenant clause is that the anchor tenant will attract a large enough traffic volume into the center to attract a significant number of customers to the tenant's business. The anchor tenant clause generally grants the tenant additional rights, such as reduced rent or the ability to terminate the lease, if the anchor tenant ceases operations within the retail center. Again, anchor tenant clauses are common in retail leases but seldom used in office leases for obvious reasons.

1. **Sample Anchor Tenant Clause**.

Landlord and Tenant recognize, understand and agree that [DESCRIBE ANCHOR TENANT] ("Anchor Tenant") has presently leased space in the Shopping Center and is presently operating its business therein. If, at any time during the term of this Lease, Anchor Tenant or a substitute anchor tenant operating substantially the same type and volume of business as Anchor Tenant is not open for business within the Shopping Center for a period of one hundred eighty (180) consecutive days **[, delays, closings and other events beyond Landlord's control excepted]**, Tenant shall have the right, but not the obligation, to terminate this Lease upon written notice to Landlord within thirty (30) days after the expiration of such one hundred eighty (180) day period (such thirty (30) day period being hereinafter referred to as the "Anchor Tenant Termination Period"). If Tenant fails to properly terminate this Lease prior to the expiration of the Anchor Tenant Termination Period, Tenant's right to terminate this Lease pursuant to this Section ______ SHALL AUTOMATICALLY AND IRREVOCABLY TERMINATE AND BE RENDERED OF NO FURTHER FORCE OR EFFECT. For purposes of this Section ______, a substitute anchor tenant shall be deemed to be operating substantially the same type and volume of business as Anchor Tenant if such substitute anchor tenant leases contiguous space within the Project of at least ____________ square feet of net rentable area and achieves an average monthly amount gross sales (determined in accordance with the provisions of Section ____ of this Lease) [ASSUMES A PERCENTAGE RENT PROVISION; IF NONE EXISTS, INCLUDE DEFINITION OF "GROSS SALES"] of $_______ for all full calendar months during which such substitute anchor tenant is open for business. TENANT RECOGNIZES, UNDERSTANDS AND AGREES THAT TENANT'S RIGHTS UNDER THIS SECTION ____ ARE EXPRESSLY CONDITIONED ON THE FULLY AND TIMELY PERFORMANCE BY TENANT OF ALL OF ITS OBLIGATIONS UNDER THIS LEASE, INCLUDING, WITHOUT LIMITATION, THE OPERATIONS COVENANTS CONTAINED IN SECTION ____ OF THIS LEASE. IN THE EVENT THAT TENANT FAILS TO FULLY AND TIMELY PERFORM ITS OBLIGATIONS UNDER THIS LEASE, INCLUDING, WITHOUT LIMITATION, THE OPERATIONS COVENANTS SECTION ____ OF THIS LEASE, THE TERMS AND PROVISIONS OF THIS SECTION ____ SHALL AUTOMATICALLY AND IRREVOCABLY TERMINATE AND BE RENDERED OF NO FURTHER FORCE OR EFFECT; PROVIDED, HOWEVER, THAT, IN SUCH EVENT, THE REMAINING PROVISIONS OF THIS LEASE SHALL REMAIN IN FULL FORCE AND EFFECT.

F. Radius Clause. A radius clause may be designed to protect either the landlord or tenant, depending on the situation.

1. Retail. Where percentage rent is to be paid by a tenant, landlord may utilize a radius clause in order to protect its financial interest from being diluted by a tenant with several locations in a small geographical area. This type of clause generally states that if the tenant operates another similar operation within a specified radius of the project, then the gross sales of the other operation will be included in the calculation of percentage rent under the lease. Alternately, a landlord-centered radius clause may contain an absolute prohibition on the tenant operating another store within a specified radius of the project. A radius clause designed to protect a tenant's interests may be included in a lease when a tenant is not satisfied with the protections afforded by an exclusivity clause covering only one project. This type of clause prohibits a landlord from leasing space to a competing tenant in any project owned or controlled by the landlord within a specified geographical area.

2. **Practice Pointer**. Radius clauses for the benefit of a tenant are very dangerous for landlords, since the ownership in the other, restricted, retail center may, then or in the future, be different from the ownership in the retail center in question. An investor in the other center will not be happy to learn that the landlord has restricted one center for the benefit of another one.

3. **Office**. Radius clauses are not typically used in office leases, the exception again being certain medical office buildings.

4. **Sample Radius Clauses**.

Landlord Protective.

Tenant shall not directly or indirectly engage in any similar or competing business to that conducted by Tenant in the Premises within a radius of two (2) miles from the Shopping Center. If Tenant does engage directly or indirectly in any such similar business within the stated two (2) miles, then in addition to all other remedies available to Landlord, Tenant's gross sales in such similar or competing business shall be reported to Landlord as in this Lease required and same shall be added to Tenant's Gross Sales made in the Premises, and Percentage Rent shall be calculated thereon.

Tenant Protective.

During the term of this Lease and for so long and only so long as Tenant fully and timely complies with all of its obligations under this Lease, Landlord agrees to and shall refrain from entering into any new leases in any retail project owned or controlled by Landlord and within __ miles from the Shopping Center which permit, expressly or impliedly, the tenant thereunder to operate a business within such project consisting of [DESCRIBE EXCLUSIVE USE IN DETAIL; ENSURE CONSISTENCY WITH USE PROVISION]; provided, however, that the provisions of this Section _____ shall not apply to any leases existing on the date of this Lease or any renewals, extensions or replacements of such leases. TENANT RECOGNIZES, UNDERSTANDS AND AGREES THAT THE PROVISIONS OF THIS SECTION ____ IS EXPRESSLY CONDITIONED UPON THE FULL AND TIMELY PERFORMANCE BY TENANT OF ALL OF ITS OBLIGATIONS UNDER THIS LEASE, INCLUDING, WITHOUT LIMITATION, THE OPERATIONS COVENANTS CONTAINED IN SECTION ____ OF THIS LEASE. IN THE EVENT TENANT FAILS TO FULLY AND TIMELY PERFORM ITS OBLIGATIONS UNDER THIS LEASE, INCLUDING, WITHOUT LIMITATION, THE OPERATIONS COVENANTS CONTAINED IN SECTION ____ OF THIS LEASE, THE PROVISIONS OF THIS SECTION ____ SHALL AUTOMATICALLY AND IRREVOCABLY TERMINATE AND BE RENDERED OF NO FURTHER

FORCE OR EFFECT; PROVIDED, HOWEVER, THAT IN SUCH EVENT, THE OTHER TERMS AND PROVISIONS OF THIS LEASE, INCLUDING, WITHOUT LIMITATION, THE OPERATIONS COVENANTS CONTAINED IN SECTION ____ OF THIS LEASE, SHALL REMAIN IN FULL FORCE AND EFFECT. IN ADDITION, THE OBLIGATIONS OF LANDLORD UNDER THIS SECTION ____ WITH RESPECT TO ANY OTHER RETAIL PROJECT SHALL APPLY ONLY DURING THE PERIOD OF TIME LANDLORD OWNS OR CONTROLS SUCH PROJECT AND SHALL AUTOMATICALLY AND IRREVOCABLY TERMINATE AND BE RENDERED OF NO FURTHER FORCE OR EFFECT IF LANDLORD, EVEN TEMPORARILY, CEASES TO OWN OR CONTROL SUCH CENTER.

G. Drafting Considerations.

1. **Use Clause versus Operations Clause**. Texas law provides that a use clause, in and of itself, does not require a tenant to actually commence and maintain operations on the leased premises. *Weil v. Ann Louis Shops, Inc.*, 281 S.W.2d 651 (Tex. Civ. App.--San Antonio 1955, writ ref'd). In Weil, the lease in question provided that the leased premises could be used for the sale of "Ladies', Misses', and Children's ready to wear and accessories and not otherwise." *Id.* at 653. In holding that such language was merely a permissive use clause and did not require the tenant to commence and maintain operations, the court noted:

> The Tenant is under no obligation in the absence of a specific provision therefor, to occupy or use or continue to use, the leased premises, even though one of the parties, or both, expected and intended that they would be used for the particular purpose to which they seemed to be adapted or constructed. . . .

Id. at 654. Thus, merely including a use provision in a lease providing that the premises will only be used for certain stated purposes does not generally obligate the tenant to commence and maintain operations. One Texas case that did find an implied covenant to operate involved a situation in which the tenant leased space in a project pursuant to a lease requiring the payment of only percentage rent, with no minimum rent required. *Marvin Drug Co. v. Couch*, 134 S.W.2d 356 (Tex. Civ. App.--Dallas 1939, dism'd judgment correct). In the *Marvin Drug Co.* case, the court was apparently persuaded by the fact that the lease provided for no minimum rent and the fact that the project was in operation at the time the lease was executed, such that the parties undoubtedly had an idea of the likely amount of gross receipts that would be received over the term of the lease. *Id.* Few if any subsequent Texas cases that cite *Marvin Drug Co.* for the proposition that an implied covenant to operate will be found. Accordingly, if the landlord desires to require the tenant to commence and maintain operations, the lease must contain an operations clause.

In many commercial lease transactions, especially retail leases, it is very important to the landlord that the project be filled with tenants actually operating the desired mix of businesses. Accordingly, the lease should contain a clause pursuant to which the tenant expressly covenants to commence and maintain operations, including the particular days and hours of the day during which the business must be open. The careful drafter should include the following matters in an operations clause:

(a) a requirement that tenant conduct its business in the premises continually on all days and at all times of the day during which the project is open, possibly excluding certain stated holidays and other limited periods of time during which the tenant deems it necessary or desirable to close its business to take inventory or perform other normal and customary business operations;

(b) a requirement that the tenant keep its store continuously stocked with the appropriate quantity and quality of merchandise or other materials necessary for the operation of its business (in other words, to prohibit the use of the premises as a staging area, for storage or as a clearance center);

(c) a requirement that the tenant maintain the appropriate quantity and quality of employees necessary for the operation of its business;

(d) a requirement that the tenant operate its business in the same fashion as operations of its kind are presently conducted by tenant (or perhaps by other benchmark operators) in the applicable market area in which the project is located;

(e) a requirement that the tenant use its best (or at least reasonable) efforts to achieve a maximum sales volume, including, without limitation, specific obligations regarding advertising and other promotions;

(f) a requirement that the tenant conduct its business under the name designated as the tenant's business name in the lease;

(g) if appropriate, a requirement that the tenant utilize not less than a stated percentage of the floor area of the leased premises for retail sales activities; and

(h) a specific statement that any breach by the tenant of the operations clause will automatically result in the irrevocable termination of any exclusivity clause contained elsewhere in the lease.

Item (h) is an essential element of the operations clause necessary to avoid the disastrous consequences previously alluded to. If the lease contains an exclusivity clause and either does not contain an operations clause or contains an operations clause that does not provide for the termination of the exclusivity clause in the event of a breach by the tenant, the landlord could find itself in a precarious position. For example, suppose the tenant is a major supermarket and the anchor tenant of the center. Suppose further that the lease grants the tenant the exclusive right to operate a supermarket within the center but does not contain a properly drafted operations clause. If the tenant's operations in the center are subsequently found by the tenant to be unprofitable, the tenant could make the business decision to cease its operations within the center while remaining current in the payment of rent and the performance of other obligations under the lease. In such event, the landlord would not be able to retake possession of the premises, based upon the tenant's breach of the absent or insufficient operations clause, and attempt to relet the premises to a substitute anchor tenant. To make matters worse, the landlord would also be unable to lease any space in the project to a supermarket since the tenant's exclusivity clause would remain in effect. As will be discussed later, the already unfortunate situation could be further complicated should other leases within the center contain anchor tenant clauses granting the other tenants additional rights should the anchor tenant cease operations within the center. Accordingly, it is essential that a carefully drafted operations clause be contained in any lease of retail space within a commercial project, especially if the lease contains an exclusivity clause. As previously mentioned, a retail tenant may strongly resist an operations clause. If so the lease should give the landlord another effective avenue to address the tenant's election to cease operations, such as the right to terminate the lease and relet to a new tenant who will open for business.

Often, the tenant will request that the landlord agree to provide the tenant with written notice and opportunity to cure prior to exercising any remedy as a result of the tenant's non-monetary default. Although, in most cases, such a request is not unreasonable, such a provision can eliminate or reduce the effectiveness of an operations clause. For example, suppose the lease requires the landlord to provide the tenant with written notice and a thirty (30) day opportunity to cure prior to exercising any remedy resulting from the tenant's non-monetary default. Obviously, a violation of the operations clause is a non-monetary default, such that notice and opportunity to cure would be required. If the notice and opportunity to cure provision is not carefully worded, the tenant could simply cease operations within the center, await the written notification from the landlord and delay the recommencement of operations until near the end of the cure period. A clever manipulation of such a provision could allow the tenant to significantly avoid the obligations of the operations clause. Accordingly, the careful drafter should ensure that either the operations clause is excluded from the notice and opportunity to cure requirements otherwise applicable to non-monetary default or, if the notice and opportunity to cure requirements are to be applicable to violations of the operations clause, provide that the landlord shall only be required to provide such notice and opportunity to cure a stated number of times, such as once or twice, during the term of the lease.

2. **<u>Enforcement of Operations Clauses</u>**. Traditionally, Texas law has been unclear with regard to whether a landlord could obtain a decree of specific performance requiring the tenant to operate its business during the state time. The argument against specific performance arises from the customary prerequisites for equitable relief requiring that the party seeking such relief show the absence of an adequate remedy at law as well as a likelihood of irreparable harm. *Parkem Industrial Services v. Garton*, 619 S.W.2d 428 (Tex. App.--Amarillo 1981, no writ). In addition, there is the longstanding doctrine that courts are reluctant to grant specific performance of contracts that are not subject to immediate performance. *Canteen Corporation v. Republic of Texas Properties, Inc.*, 773 S.W.2d 398 (Tex. App.--Dallas 1989, no writ). The policy behind this line of cases is that the courts deem it impossible or, at a minimum, inefficient to police the actions of the parties over an extended period of time. *Id.*

a. **<u>Canteen Corporation</u>**. In *Canteen Corporation v. Republic of Texas Properties, Inc.*, 773 S.W.2d 398 (Tex. App.--Dallas 1989, no writ), the Dallas Court of Appeals was faced with a situation in which a lease provided that the premises would only be used for purposes of a restaurant. The tenant subsequently closed down its full service restaurant and installed vending machines. The trial court enjoined the vending machine operation and ordered the tenant to resume operation of the restaurant. In overturning the order requiring the tenant to resume the operations of a restaurant, the court of appeals stated:

> It is well established that a court of equity will only order specific performance when present performance is possible. A court will generally not decree a party to perform a continuing series of acts which extend through a long period of time and require constant supervision by the court.

Id. at 401. Thus, although the court upheld the injunction preventing the tenant from operating vending machines in the premises, it struck down that portion of the trial court's order requiring the tenant to operate a restaurant on the theory that the contract was not capable of present performance. Accordingly, in most cases covenants to operate are not subject to specific performance. Such clauses do, however, result in the tenant being in default under the lease if it ceases to operate, thereby giving the landlord the right, at a minimum, to retake possession of the leased premises and find a replacement tenant who is ready, willing and able to conduct its operations therein.

Returning to our prior example, suppose the supermarket's lease contained a properly drafted operations clause that required the tenant to operate its business in the premises during stated times. This provision, in and of itself, would very likely have an adverse impact on the tenant's decision to cease operations within the center while continuing to pay rent under the lease. If the tenant did elect to cease operations, the tenant would be in default under the operations clause, allowing the landlord to retake possession of the premises and attempt to relet it to a substitute anchor tenant.

b. <u>Public Interest Exception</u>. One possible exception to the courts' unwillingness to enforce specific performance of operations clauses is the situation where the operations in question are deemed to be for the benefit of the public at large. In *Municipal Gas Co. v. Lone Star Gas Co.*, 259 S.W. 684 (Tex. Civ. App.--Dallas 1924), aff'd on other grounds, 3 S.W.2d 790 (Tex. 1928), the court compelled the delivery of natural gas purchased by the plaintiff for distribution to its customers. *Id.* In rejecting the defendant's contention that specific performance should not be granted because the contract in question was not capable of present performance, the court stated:

> [T]his rule of decision contended for by [defendant] finds no place in a case that touches the public interest as does the subject-matter of these contracts.

Id. at 691.

3. <u>Use Clause versus Exclusivity Clause</u>. As previously noted, once the landlord has granted an open-ended use clause, the landlord will, in effect, be prohibited from granting any exclusivity clauses in future leases. For example, if the landlord in our prior example has previously executed one or more leases in the project providing that the tenant can use the premises for any lawful purpose, the landlord cannot then grant the subsequent tenant the right to have the only supermarket in the project. If the landlord did so, it would be subject to significant exposure should one of the existing tenants with an open use clauses elect to open a supermarket, thereby causing the landlord to be in default under the exclusivity clause contained in the subsequent lease.

One possible compromise is to provide that the landlord will not grant any subsequent tenant the right to operate any business prohibited by the exclusivity clause. These provisions must be carefully drafted, however since disputes can arise with regard to the renewal or expansion of existing "grandfathered" leases. A tenant who is presently in the project under an open-ended use clause may strongly resist including a more restrictive use clause in any renewal or replacement lease. In sum, the landlord should use extreme caution in granting any exclusivity clauses and, to the extent possible, only consider granting an exclusivity clause to an anchor tenant that intends to operate in the center over an extended period of time. Finally, it is of extreme importance that any exclusivity clause be expressly conditioned upon the tenant's compliance with all of its obligations under the Lease, expressly including a carefully drafted operations clause. To do otherwise could result in the tenant ceasing operations but otherwise maintaining the lease in place. If the exclusivity clause is not conditioned upon the compliance with the operations clause, the landlord in our prior example would be in the disastrous position of being unable to place a supermarket in the project, while having no existing supermarket in the project since the tenant had ceased operations.

4. **Anchor Tenant Clause**. The careful drafter should also use extreme caution in drafting a requested anchor tenant clause to ensure that the clause will expressly provide who and what constitutes an anchor tenant for purposes of the clause. In *Lilac Variety, Inc. v. Dallas Texas Company*, 383 S.W.2d 193 (Tex. Civ. App.--Dallas 1964, writ ref'd n.r.e.), the Dallas Court of Appeals was faced with a lease to a variety store that provided that "at all times during the term of this lease . . . the supermarket, department store, and other major tenants shall remain as tenants and located as per proposed location on Exhibit "C" at all times during the term of this lease or any extension thereof." *Id.* at 194.

During the term of the variety store lease, the supermarket discontinued operations and its premises remained vacant except for use for the storage of fixtures and other property previously owned by the supermarket and used in connection with its operations. The supermarket's lease, however, was not terminated. In holding that the anchor tenant clause contained in the lease gave the variety store the right to terminate the lease, the court noted

> Plainly the parties intended that a supermarket should be in operation during the term of the lease. We find it impossible to believe that when the parties entered into this lease agreement it was intended that the particular lease provision in question should be satisfied if [the supermarket] should continue to pay rent on an idle store building after discontinuing operation of the supermarket.

Id. at 196.

The careful drafter should include language in the anchor tenant clause providing the landlord with ample time to find a replacement anchor tenant should the initial anchor tenant cease operations and default under its lease. The clause should be drafted in such a manner as to give the landlord whatever time is reasonably necessary to obtain a replacement anchor tenant and the anchor tenant ample time to make the premises ready for the operation of its business. Ideally, this time period should be extended by any delays caused by matters beyond the landlord's control. If the landlord's bargaining position makes it possible, the careful drafter should draft an anchor tenant clause that gives the tenant options other than terminating the lease in the event the anchor tenant ceases operations within the center for a stated period of time. For example, some anchor tenant clauses grant the tenant the right to a reduction in rent, either represented by a reduction in the stated rent or the right to pay only a specified percentage rent, as opposed to the right to terminate the lease. The anchor tenant clause could also require actual damages prior to the reduction in rent or termination. If the cessation of operations by the anchor tenant has no actual effect on the gross sales of the tenant, it may not be fair for the tenant to be able to terminate its lease simply because the anchor tenant ceases operations. In sum, the anchor tenant clause needs to be carefully drafted to protect each party's interest without unduly penalizing either party.

Returning to our prior example, suppose other leases in the center contained anchor tenant clauses giving the other tenants the right to terminate their leases should the anchor tenant, in this case the supermarket, cease operations within the center. If the anchor tenant clauses do not contain language giving the landlord additional time to find a substitute anchor tenant, the other tenants could theoretically terminate their leases on the first day the supermarket ceases operations. If, however, the anchor tenant clauses were carefully drafted, they would give the landlord time to retake possession of the anchor tenant's premises, locate a substitute anchor tenant and make the space ready for the operation of the substitute anchor tenant's business. Again, it is essential that the anchor tenant's lease contain an operations clause since the absence of an operations clause would prevent the landlord from retaking the tenant's space should it cease operations. Thus, a carefully drafted anchor tenant clause in one lease can be rendered useless by the absence of an operations clause in the anchor tenant's lease.

5. **Operations Clause versus Anchor Tenant Clause**. As noted, landlord should never include an anchor tenant clause in a lease unless the anchor tenant's lease contains an operations clause. To do so could lead to the disastrous result of the anchor tenant ceasing operations, without being in default under its lease due to the absence of an operations clause, thereby causing the landlord to be in default under the anchor tenant clause without being able to retake possession of the anchor tenant's premises and place a substitute anchor tenant therein. Furthermore, any lease containing an anchor tenant clause should also contain an operations clause. If the tenant is seeking the landlord's agreement that the landlord will at all times cause an anchor tenant to be operating in the center, it is only fair that a tenant agree to conduct its operations in the center during stated times. At a minimum, the anchor tenant clause should terminate in the event the tenant ceases operations within the center. Returning to our prior example, suppose a smaller tenant in the project has previously has ceased operations, but realizing its obligations under its lease, has continued to pay rent. As a practical matter, the cessation of operations by the anchor tenant has no adverse impact on the smaller tenant, since the smaller tenant is not operating its business. The smaller tenant does, however, have a significant interest in avoiding liability under its lease. If the lease contains an anchor tenant clause, giving the tenant the right to terminate the lease should the anchor tenant cease operations, the tenant has an easy means to escape liability under its lease. Accordingly, the careful drafter should not only provide that the anchor tenant clause will automatically and irrevocably terminate upon the cessation of operations by the tenant, but should also couple the anchor tenant clause with an operations clause requiring the smaller tenant to operate its business during stated hours. It is important to keep in mind that, much as the smaller tenants look to the anchor tenant to draw customers to the project, the anchor tenant looks to the smaller tenants, in

the aggregate, to both draw customers to the project and to provide additional amenities to its customers.

IV. RENT.

Monthly rent, often called "Base Rent," is only one component included in the cost of leasing space. The additional types of rent vary greatly based on the type of space being leased. Virtually every lease, whether for office or retail space, requires the tenant to pay all or a portion share of the project's operating costs, either directly (as is often the case with retail leases) or on a prorate basis (as is often the case in office leases). The discussion below will focus on the differences between the costs a tenant can anticipate paying based on the type of space being leased. The way in which total rent is calculated varies greatly based on, among other things: (a) the quality of the premises; (b) the degree of risk the particular landlord is willing to accept; (c) whether the lease is generally considered to be a gross or a net lease; and, of course (d) whether the lease is for retail or office space.

A. Operating Costs. In an effort to provide landlords an incentive to prudently manage operating costs, tenants may ask for a cap on operating costs increase. Many landlords will not agree to such limit for certain operating costs, i.e., utilities, taxes and insurance on the grounds that these expenses are largely outside of the landlord's control. Even for so-called controllable operating costs, landlords are often resistant to caps on operating costs increases. Rather than cap operating costs, many leases allow a tenant audit rights. Audit right provisions vary significantly from lease to lease, but their purpose is to allow the tenant to audit Landlord's books to determine whether Landlord has been prudent accounting for and allocating operating costs. From a tenant's perspective, audit rights in and of themselves are a poor substitute for an expense cap, since the audit merely tests the landlord's accounting and not the landlord's efforts to keep operating expenses in check. An audit provision combined with a well drafted operating expense exclusions provision will provide the tenant with some protection.

1. Net Leases. In addition to Base Rent, landlords often utilize a net lease in order to reduce financial risk associated with increases in operating costs of a project. Through the use of net leases, landlords pass all (or at least as many as possible) operating costs directly through to tenants, who pay a pro-rata share of such costs based on their pro-rata share of the total rentable area of the project.

True net leases do not require the landlord to pay any operating expenses (e.g., they do not include a "base year" or "expense stop" component). Thus, the base rent is net of operating costs, taxes and insurance.

Although the definition of operating costs differs from lease to lease, based on the custom and practice of the area and the negotiating power of the parties, a general definition of operating costs might be: All direct and indirect costs and expenses incurred in each calendar year in connection with operating, maintaining, repairing, managing, and owning the project. Often, tenants negotiate for a list of items that will not be included in the computation of operating expenses (and, thus, must be paid by the landlord). Typical exclusions include depreciation, interest, certain capital expenses, leasing commissions, principal payments on a mortgage or other non-operating debts of the landlord.

Many retail leases require the tenant to pay a significant portion of these expenses directly. Utility costs, insurance, taxes (if the premises is a separate tax parcel) and maintenance costs are often paid directly by the tenant under a retail lease. Many major retailers prefer this, since they believe they can control and reduce costs better than the landlord.

2. **Hybrid Leases**. Most leases, including retail and office leases, are actually hybrid leases, that contain some net lease provisions, but either require the landlord to bear some of the operating expenses or contain a component of the base rent (e.g., base year or expense stop) that covers a portion of the operating expenses, with the tenant only required to pay operating expenses in excess of that component. For example, a retail lease might require the landlord to replace the roof if and when required, while requiring the tenant to pay for all other maintenance. Similarly, an office lease may require the landlord to pay all operating expenses for the base year (e.g., the first calendar year of the lease term) and require the tenant to pay any increases in such expenses in subsequent years.

3. **Practice Pointer**. There are a lot of leases that are called "net leases" or "triple net" leases that are actually hybrid leases.

4. **Gross Leases**. Gross leases, which are rarely used in Texas, require the tenant to pay only a stated amount of rent, with all operating expenses paid by the landlord.

5. **Percentage Rent**. Percentage rent is often, though not always, used in retail leases. The components of the percentage rent clause are (a) the sales base or breakpoint; (b) the applicable percentage; and (c) gross sales. Percentage rent is determined for any calendar year by multiplying the applicable percentage (expressed as a fraction) by the amount of gross sales in excess of the breakpoint. During negotiations tenants will attempt to reduce percentage rent by (i) excluding as much revenue from gross sales as possible and/or offsetting as many expenses as possible; (ii) lowering the applicable percentage; and (iii) increasing the breakpoint (the higher the breakpoint, the lower the percentage rent). Conversely, the landlord will be interested in reversing this process in order to obtain the highest return.

a. **The Breakpoint**. Percentage rent is in addition to the base rent (often called guaranteed minimum rent in a retail lease). When a tenant's sales volume reaches a certain point, all sales over that amount will be multiplied by the applicable percentage and the tenant will owe the resulting sum to the landlord as additional rent. This certain point is referred to variously as the sales base, gross sales base, or breakpoint (but more commonly the breakpoint).

1. 6. **Natural Breakpoint**. The most common basis for determining the breakpoint is to set the figure at that amount which, when multiplied by the agreed percentage, equals base rent. Two common methods are used to make this calculation.

a. The first method is simply to divide the annual base rent by the applicable percentage and enter the resulting amount into the lease as the breakpoint. For example, assume a base rent of $100,000.00 per year and an applicable percentage of 5%. The natural breakpoint would be $2,000,000.00 in gross sales.

b. The second method is to place the following formula into the lease: (gross sales x applicable percentage) minus base rent = percentage rental.

These formulas will produce the same percentage rent unless there is a reduction or increase in the base rental during the term of the lease. The second method has a built in adjustment factor for changes in the base rent.

7. **The Unnatural Breakpoint**. Alternatively, the landlord and tenant can agree on some other breakpoint. A breakpoint lower than the natural breakpoint would favor the landlord. A breakpoint higher than the natural breakpoint would favor the tenant.

8. **Modification of Percentage Rate**. Tenants often negotiate to deduct tax payments, insurance payments, common area maintenance charges, and/or other pass-throughs from percentage rent. Note that it is not the same as deducting various expenses from gross sales (discussed below). A credit against percentage rent is a dollar-for-dollar deduction whereas a deduction from gross sales reduces the amount multiplied by the applicable percentage. For example, suppose the tenant owes percentage rental of $25,000.00 computed as 5% of $500,000.00 in gross sales above the breakpoint, and has $10,000.00 in deductible CAM charges. A credit would reduce the percentage rental obligation to $15,000.00. If the $10,000.00 were deducted from gross sales the percentage rent would only be reduced by $500.00 (5% of $10,000.00).

9. **The Applicable Percentage**. In determining the applicable percentage for each type of retail tenant, the parties must take into consideration how percentage rent fits into its pattern of sales. Some retailers, such as a supermarket, may have a high volume of sales but a low margin of profit. Such an operator will want a low percentage. Other retailers, such as a furniture store or some restaurants, may have low volume but a high mark up. Landlords should be cognizant of the general economics of each tenant's business during negotiation of percentage rent. The landlord may be content with a rate of from 1% to 1 3/4% from a chain supermarket. The same landlord may insist on a higher percentage from a jeweler operating with much higher margins.

10. **Gross Sales**. Percentage rent is usually based upon gross sales but may be based on any other measure of business success agreed upon, such as net profits, etc. Landlords generally prefer gross sales to net profits or other measures which may penalize the landlord for the tenant's inefficiency or poor management. The agreed upon calculation may include numerous customized provisions for the inclusion or exclusion of specific types of revenue or expenses. Regardless of traditional accounting norms, the lease will be construed according to the language used to define the rights and obligations of the parties.

a. **What Landlords Want In**.

i. All cash or credit sales,

ii. Interest, time-price differential, finance charges and service charges on time-payment sales.

iii. Orders received in person or by mail or telephone whether delivery is made or order taken on or off premises.

iv. Vending machine receipts.

v. Deposits not refunded to customers.

b. What Tenants Want Out.

i. All credits and refunds made to customers for merchandise returned or exchanged.

ii. Vending machines receipts.

iii. Sums received from claims for loss of or damage to merchandise.

iv. Sales taxes, excise taxes, etc, paid by tenant.

v. Sales to employees at discount.

vi. Transfers of merchandise to an affiliated store or warehouse made in the regular course of tenant's business.

vii. Lay-a-way sales and sales on credit or part credit.

viii. Bulk sales not in the ordinary course of business.

ix. Sales of trade fixtures or equipment.

x. Bad debts.

xi. Loss leader or accommodation sales.

xii. Promotional expenses.

xiii. Off site delivery and service calls (note the conflict with the inclusions).

xiv. Off-Premises operations.

xv. Proceeds of concessions, sublessees, or agents operations.

xvi. Cost of construction, repairs and improvements, if applicable.

xvii. Taxes and insurance. This is a fall-back position of tenant to a direct credit against percentage rent. If method #2 above is used and taxes and insurance are defined as additional rent the tenant may get his credit. Landlord will argue that it is rent for some purposes but not "base rent".

xviii. Depreciation and interest. Sometimes requested but rarely given.

xix. Employee benefits.

xx. Utilities.

xxi. Ancillary or incidental operations (*e.g.*, sale of traveler's checks, lottery tickets, etc.).

These inclusions and exclusions are negotiable and should be considered carefully, on a case by case basis. For example, there have been a number of disputes between landlords and tenants as to whether lottery payments to stores that sell winning tickets should be included in gross sales.

11. Sample Percentage Rent Clause.

Percentage Rent.

(1) Payment Quarterly. Tenant shall pay to Landlord for the Premises as additional rent, without demand, setoff or deduction, a sum (the "Percentage Pent") equal to the amount, if any, by which the percentage, set forth in Article I hereof, of the Gross Sales (as hereinafter defined) of Tenant made from or upon the Premises each calendar year, or portion thereof at the beginning or end of the term of this Lease, exceeds the Minimum Annual Rent paid under Section 4.A. above for such period. On or before the tenth (10th) day of each month, Tenant shall furnish Landlord with a statement in writing certified by Tenant, if Tenant is an individual or partnership, or by an authorized officer of Tenant if Tenant is a corporation, setting forth the Gross Sales for the preceding month (or portion thereof if at the beginning or end of the term of this Lease). On the tenth (10th) day of each January, April, July and October, Tenant shall pay to Landlord the amount by which the sun so computed as a percentage of Gross Sales during such preceding quarter exceeds the portion of the Minimum Annual Rent which Tenant shall have paid during such quarter.

(2) Annual Adjustment. Within thirty (30) days after the close of each calendar year during the term of this Lease, Tenant shall furnish Landlord with a statement in writing signed and certified as correct by a certified public accountant and by Tenant, if Tenant is an individual or partnership, or by an authorized officer of Tenant if Tenant is a corporation, setting forth the Gross Sales for the preceding calendar year. If Tenant shall have paid Landlord an amount greater than Tenant is required to pay under this Section 4.B., Landlord shall credit such amount against the rent next coming due. If Tenant shall have paid an amount less than Tenant is required to pay under Section 4.B., then Tenant shall pay the difference to Landlord concurrently with delivery of such annual statement. For purposes of computing the Percentage Rent, if the Commencement Date shall be a day other than January 1, the first calendar year shall be considered to be the period from the Commencement Date to the next succeeding December 31, and the last calendar year shall be considered to be from January 1 to the expiration or termination date.

(3) Records of Sales. Tenant shall keep at the Premises or at Tenant's principal place of business in the State containing the Premises (the location of which Tenant shall advise Landlord in writing), full and accurate books of account, records and other pertinent data (including all supporting records such as original sales slips and checks, reports on excise and selling taxes and cash register tapes) of the Gross Sales relating to the Premises (including the Gross Sales of any subtenant, licensee or concessionaire). All sales shall be registered upon non-resettable cash registers with locked-in totals or such other control systems as Landlord may

approve. Tenant shall, upon Landlord's request, furnish a copy, certified as true, of the sales tax reports, insofar as such reports pertain to the Premises, filed by Tenant with the governmental authority charged with the collection of sales tax covering any period of time for which Tenant has furnished a statement of Gross Sales to Landlord. Such books and records shall provide records of each day' s sales so that a day-by-day record is maintained, and shall be retained for a period of four years after the close of each calendar year. The acceptance by Landlord of any statement or any payment of Percentage Rent for any period shall not bind Landlord as to the correctness of the statement or the payment. At any time within two years after the receipt of any such statement, Landlord shall be entitled to conduct an audit of such Gross Sales either by Landlord or by a certified public accountant designated by Landlord. Such audit shall be limited to the determination of Gross Sales and shall be conducted during normal business hours. If such audit shall reveal a deficiency in the payment of Percentage Rent, Tenant shall immediately pay such deficiency with interest at the rate of ten percent (10%) per annum from the date when such deficiency should have been paid. In addition, if any of Tenant's annual statements of Gross Sales shall be found to have understated Gross Sales by two percent (2%) or more, then Tenant shall pay all of Landlord's costs and expenses connected with such audit. In the event that Tenant fails to submit any annual statement of Gross Sales when due, Landlord may so notify Tenant; if Tenant does not submit such statement within ten (10) days after delivery by Landlord of such notice, then Landlord may make an audit of Tenant's books and records relating to the Gross Sales for the preceding year. Such audit shall be commenced within ninety (90) days after the date by which such statement should have been submitted. Any such audit shall be final and binding upon both parties. In the case of any audit made by Landlord as a result of Tenant' s failure to submit an annual certified statement of Gross Sales when due, Tenant, within five (5) days after demand by Landlord, shall pay to Landlord the additional Percentage Rent that may be due, computed in accordance with the provisions of this Lease upon the basis of such audit, together with the expense of such audit. Any information gained from Tenant's quarterly and annual statements or from an audit shall be confidential and shall not be disclosed other than to carry out the purposes hereof; provided, however, Landlord shall be permitted to divulge the contents of any such statements or audit in connection with any financing arrangements or assignments of Landlord's interest in the Premises or in connection with any administrative or judicial proceedings in which Landlord is required to divulge such information.

(4) Definition of Gross Sales. The term "Gross Sales" as used in this Lease shall mean the gross selling price of all merchandise or services sold, leased, bartered, or exchanged at, in or f ran the Premises by Tenant, its subtenants, licensees and concessionaires, including mail and telephone orders taken on the Premises, and including all deposits not refunded to purchasers, and including all other revenues of Tenant's Business conducted at, in or f ran the Premises by Tenant, its subtenants, licensees and concessionaires, whether for cash or on credit, and whether made by store personnel or by vending or other coin-operated machines, excluding therefrom as they relate to the Premises, the following:

(i) The selling price of all merchandise returned by customers and accepted for full credit or the amount of discounts and allowances made thereon, provided such selling price had previously been included in Gross Sales;

(ii) The exchange of merchandise between stores or warehouses owned by or affiliated with Tenant, where such exchanges are made solely for the convenient operation of Tenant's business and not for the purpose of consummating a sale which has theretofore been made at, in or from the Premises;

(iii) Goods returned to shippers or manufacturers;

(iv) Sums and credits received in the settlement of claims for loss of or damage to merchandise;

(v) The price allowed on all merchandise traded in by customers for credit or the amount of credit for discounts and allowances made in lieu of acceptance thereof;

(vi) Cash refunds made upon transactions included within Gross Sales, not exceeding the selling price of the merchandise returned by the purchaser and accepted by Tenant, and not including the value of any trading stamps or other stamps or coupons which may be transferred or credited to the purchaser in connection with any sale; and

(vii) Sales taxes, so-called luxury taxes, consumers excise taxes, gross receipts taxes and other similar taxes now or hereafter imposed upon the sale of merchandise or services, but only if collected separately from the selling price of merchandise or services.

All sales originating at, in or from the Premises, whether for cash or on credit, shall be considered as made and completed therein, even though bookkeeping and payment of the account may be made at another place and even though the actual delivery of merchandise or performance of a service may be made f ran or at a place other than the Premises.

B. Inflation Indexes. Although used in both office and retail settings, inflation indexes are more commonly seen in office leases. Escalation of rent based upon cost-of-living indexes can provide substantial revenue increases to landlords during periods of inflation. The stated purpose of the cost-of-living escalation clause is to protect the landlord's real return against erosion from the shrinking value of the dollar by reason of inflation. The index most commonly used is the CPI-U (the National Consumer Price Index for all Urban Consumers) issued by the Bureau of Labor Statistics, but the index or formula utilized in a particular lease may be varied. Although not designed to relate to commercial property inflation, but as a statistical measure of the change in the prices of a simple "market basket" of goods and services typically purchased by urban consumers, the CPI-U is the almost universally used device for adjusting base rent, in part because it is the most readily available measure of inflation and is widely accepted for that purpose. The idea is simply to adjust the rent upward to keep pace with inflation. However, when combined with the pass-through of operating expenses discussed above, it can result in a wind-fall for the landlord. There is a "double dip" effect when costs are passed through and an inflation index is used.

1. Essentials of the Clause. Most escalation clauses should specify the base rent which is subject to the adjustment clause and the official name, subtitle, component, source, and geographic designation of the index being used. The clause should also establish a base period from which the changes in the index will be measured, the frequency and mechanics of the adjustment and any caps or limitations on the escalation.

2. Sample Inflation Index Clause.

Alternative 1 (Complicated)

Beginning at the commencement of the second Lease Year and upon the commencement of each Lease Year thereafter during the Term, the monthly Base Rent for the Lease Year in question shall be calculated by multiplying the then current monthly Base Rent by a fraction determined as follows:

(a) The numerator shall be the Current Index (as defined below); and
(b) The denominator shall be the Initial Index(as defined below).

Provided, however, that if such computation would cause the monthly Base Rent for the Lease Year in question to decrease below the amount of monthly Base Rent for the immediately preceding Lease Year, then the monthly Base Rent for such Lease Year shall be the same as the Base Rent for the immediately preceding Lease Year (e.g., no adjustment shall be made during such Lease Year).

The term "Index", as used herein, shall mean the Consumer Price Index for All Urban Consumers (CPU-U) for the U.S. City Average for All Items (1984=100) published by the United States Department of Labor, Bureau of Labor Statistics.

The term "Initial Index" shall mean the Index published for ___________, 20__. The term "Current Index" shall mean the Index published for the month of ____________ for the calendar year in which the Lease Year for which monthly Base Rent is being calculated commences.

If a base year other than 1984 is adopted by the United States Department of Labor, Bureau of Labor Statistics, the Index shall be converted in accordance with an appropriate conversion factor in order to ensure that all increases in the consumer price index are taken into account. If the Index is discontinued or revised, such other index or computation with which it is replaced, or if no official replacement is named, such other comparable statistics published by a responsible financial periodical or recognized authority as are reasonably acceptable to Landlord and Tenant shall be used in order to obtain substantially the same result as would have been obtained it the Index had not discontinued or revised.

Alternative 2 (Simple)

Section ___. Adjustment of Base Rent.

The Base Rent shall be adjusted [**upward, but not downward,**]as of the first day of January during each calendar year that commences during the term of this Lease (the "CPI Adjustment Date") by the amount of the increase, if any, in the CPI (as defined below) in effect for December of the immediately preceding calendar year (the "Most Recent Calendar Year") over the CPI in effect for December of the calendar year immediately preceding the Most Recent Calendar Year. The term "CPI" shall mean the Consumer Price Index for All Urban Consumers (CPU-U) for the U.S. City Average for All Items (1984=100) published by the United States Department of Labor, Bureau of Labor Statistics; provided, however, that (a) if the CPI (or any index substituted therefor as hereinafter provided) shall cease to be published, then for the purposes of this Section

___ there shall be substituted for such index another similar index published by a governmental or other nonpartisan organization as may be reasonably [**selected/agreed upon**] by [**Landlord/Tenant/Landlord and Tenant**], and (b) if there is any revision in the computation of the CPI (or any index substituted therefor as provided above), including, without limitation, a change in the base year, then for the purposes of this Section ___ such revised index shall be substituted for the index in effect prior thereto and [**Landlord shall/Landlord and Tenant shall jointly**] make such other [**reasonable**] adjustments as may be required to obtain[**, to the extent feasible,**] substantially the same result that would have been obtained if the index had not been revised.

V. CONCLUSION.

Retail leases and office leases are complex documents that are fun to draft and negotiate. Through understanding the similarities and differences in the two, a lawyer can more easily assist his or her client in the acquisition, development and leasing of commercial properties.