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Negotiating Lease Terms with the Bottom Line in Mind

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With the commercial real estate market softening and vacancy rates climbing, lenders are taking a more conservative approach in deciding which real estate development projects to finance. Coupled with tight credit markets and tougher underwriting standards, lenders are demanding more financial covenants and preleasing requirements from the developer/borrower as a condition to financing. As a result, the leverage in lease negotiations between the developer/landlord and the tenant is shifting.

During the real estate boom of the past few years, lenders were lenient in their credit decisions. The name of the game for the lenders was "book the loan and get the fees." But lately lenders are being more diligent and are no longer willing to make loans for speculative real estate developments. As a result, developers are making more concessions in the negotiation of leases for their proposed developments to increase their pre-leasing and meet one of the lender's conditions to financing.

Many developers continue to favor mixed-use developments, which contain a combination of retail and office space, with many also including a hotel. Restaurants are an integral part of the tenant mix for these developments and are positioned to demand more favorable lease terms. Below we offer six ideas on lease terms that have the potential of either increasing the restaurant tenant's prominence in the marketplace or increasing the restaurant tenant's profitability and return on investment.

1. Exclusivity – Developers/landlords have been reluctant to include an exclusivity provision that restricts the developer's/landlord's leasing options in the future. This covenant, by definition, will preclude the developer/landlord from leasing space to a competitor of the restaurant tenant within the proposed development or within a certain radius of the proposed development. Developers are now more willing to include such a provision in a lease if necessary to get the restaurant tenant's signature. This provision must be carefully drafted in order for the restaurant tenant to realize the maximum benefit, particularly if the landlord wants to tailor the clause to a restaurant niche like casual dining.

2. **Opening Co-Tenancy** – Leases typically disclaim developer/landlord representations to the proposed tenant and state that the proposed tenant is not relying on any representation from the developer/landlord, other than those specifically provided in the lease. The Opening Co-Tenancy provision allows a restaurant tenant to pay the developer/landlord reduced rent (sometimes significantly reduced depending on the circumstances) if certain other tenants, which the developer/landlord has told the restaurant tenant will open in the development, have not opened when the restaurant tenant opens for business. Inclusion of the Opening Co-Tenancy provision can financially benefit the restaurant tenant if all of the pieces of the developer's/landlord's puzzle don't fall into place when promised.

3. **Operating Co-Tenancy** – The Operating Co-Tenancy provision protects the restaurant tenant if the development does not meet the projected lease-up and opening success. This allows the restaurant tenant to pay the developer/landlord reduced rent (sometimes significantly reduced depending on the circumstances) or, in extreme cases, terminate the lease if the restaurant tenant has opened for business in the development and either (a) certain projected tenants do not open in the development or (b) a certain minimum percentage of the square footage of the development does not contain tenants (sometimes named tenants) which are opened to

the public. Again, this is a sensitive provision for the developer/landlord, but one that the developer/landlord may concede, depending on market conditions and the negotiating acumen of the restaurant tenant.

4. **Percentage Rent** – Most restaurant leases contain a provision that requires the restaurant tenant to pay to the developer/landlord a certain percentage of the restaurant tenant's gross sales once the restaurant tenant has exceeded a natural break point in sales. Restaurant tenants are now in a better position to negotiate either the percentage to be paid to the developer/landlord or the amount of the natural breakpoint in sales. The definition of "gross sales" is a relatively standard definition, but the restaurant tenant must ensure that certain receivables are excluded from the definition. Otherwise, the restaurant tenant may be paying the developer/ landlord more in percentage rent than industry standard.

5. **Leasehold Mortgage** – Most developers/landlords have been reluctant to include a Leasehold Mortgage provision in leases, usually because the developer/ landlord simply did not want to complicate the negotiation process by having its (the developer's/landlord's) lender review and approve the Leasehold Mortgage language. The Leasehold Mortgage provision is a viable financing tool for the restaurant tenant, and one that should not be categorically dismissed and excluded from a lease.

6. Rent Abatement – Developers/landlords rarely, if ever, considered a Rent Abatement provision in the past several years, even in commercial circumstances which would warrant such a concession. Now that the market has turned, developers/landlords will include abatement, although such provisions are narrowly tailored to address specific matters such as interruption in traffic flow due to construction in the development.