

RETAIL PROPERTIES

Quarterly

Legal

Resurrecting retail: Leasing issues to consider

It's true, the glittering era of shopping malls is dead. Whether you blame it on the rise of e-commerce, a cultural shift toward experiences rather than things, the oversupply of malls or millennials in general (when in doubt, blame a millennial), the rapid demise of shopping malls has been staggering.

Since the start of this year, more than 1,500 store closures have been announced and up to 25 percent of American malls are predicted to close within the next five years. While many outdated malls already have been demolished and redeveloped into open-air town centers, others have incorporated new uses into their existing structures. The general shift has been toward mixed-use developments that bring together shopping, working, living and entertaining.

With the physical structures of retail centers being updated, various retail lease provisions are in need of updating as well. Here are a few issues to consider when drafting leases in today's retail environment.

• Allocation of operating expenses.

Traditional shopping malls generally allocate operating expenses among retail tenants based on their proportionate share of the total square footage of the project.

For mixed-use developments, however, landlords will incur certain costs that benefit some tenants but not others. Therefore, landlords will need the ability to allocate different operating expenses to different tenants. For example, if a landlord creates an outdoor seating area for office employees to eat lunch, the costs of cleaning, maintaining and repairing such an outdoor seating area should be allocated solely to the office tenants.

Landlords should establish separate categories of projectwide



Heather Park Meek
Attorney, Otten Johnson, Denver

expenses and use-specific expenses, along with different denominators for the proportionate shares, for each type of tenant. If the different use components of a mixed-use development has or will have separate owners, the projectwide expenses

should be addressed in a recorded declaration.

Additionally, the desired amenities and the tenant mix will change over time. If the above-mentioned outdoor seating area is used by the employees and customers of the retail tenants or the residential tenants, a portion of the related operating expenses should then be allocated to those tenants as well. Landlords should reserve the right to determine the amenities being offered, the tenants who are benefitting therefrom and the calculation of the tenants' share allocations.

• **Percentage rent.** Percentage rent, a form of rent that is paid based on a percentage of gross sales, is a stalwart of retail leases. Percentage rent incentivizes landlords to select a complementary mix of tenants and provides tenants the flexibility to pay rent based on the profits of the business.

Today, the interplay between the in-store experience and online sales has made it exceedingly difficult for landlords and tenants to determine the gross sales that are attributable to the physical location. If a customer walks into a store, tries on a couple of items, but goes home and orders the same items online, will the purchase be included in gross sales? What if a sales associate

helps the customer order it online while in the store? Alternatively, what if a customer buys an item online and picks it up in the store?

With many retail stores decreasing their physical footprint and storing their inventory off-site, these retail situations are becoming more prevalent. Furthermore, digitally native brands, such as Warby Parker and Bonobos, are using their physical locations as "zero inventory, high-experience showrooms" rather than traditional stores for the sale of goods. While tenants may see a boost in online sales based on their physical location, landlords do not see that same boost in the gross sales reports.

If landlords want to include a portion of online sales in the calculation of percentage rent, it will need to be captured in the lease definition of "gross sales." One approach is to include online sales that are subject to state retail sales tax. In Colorado, the "Amazon tax" requires out-of-state companies to collect sales tax from Colorado residents who make online purchases. Many (but not all) states have passed similar laws.

Landlords and tenants would still need to negotiate how the total online sales are allocated among the multiple store locations (if applicable) and how to determine which online sales are connected to the physical location. These determinations could require additional information on customers' purchasing habits.

As percentage rent calculations become increasingly complicated, another approach is to eliminate percentage rent altogether and rely on other forms of rent. Landlords can still require delivery of gross sales statements in order to understand the tenants' financial conditions without the headache of determining percentage rent.

• **Co-tenancy requirements.** Retail leases in malls and shopping centers commonly include co-tenancy provisions, which allow tenants to exercise certain remedies if key tenants or a certain number of other tenants are not operating in the shopping center. Co-tenancies often are tied to an anchor tenant, such as a department store or a grocery store, under the theory that an anchor tenant will attract a large number of customers, which then creates foot traffic for the smaller tenants in the shopping center.

However, it recently was reported that approximately 324 department stores consisting of up to 37 million square feet are scheduled to close in the next couple of years. Although the grocery sector has continued to grow, some national chains are experimenting with smaller formats. While some of this available anchor space will be leased to other tenants with substantial size requirements, such as gyms, entertainment centers, music venues and schools, other anchor space will need to be divided and leased to multiple tenants. As the retail sector continually changes, landlords will want maximum flexibility to reconfigure and revitalize their projects, with or without an anchor tenant.

To the extent possible, co-tenancy provisions should be deleted entirely or tied only to a certain percentage or number of retail stores that are operating. If the project includes nonretail uses, then any nonretail space should be excluded from the co-tenancy determination.

In conclusion, landlords and tenants are being faced with a new set of expectations and obligations when negotiating retail leases. Although this article has focused on typical lease provisions that are being updated or replaced, the changing retail landscape likely will generate a number of unique lease provisions for new retail developments.▲