

Economics are the heart of any lease transaction. Whether a landlord or tenant, the strategies and tactics of negotiating monetary provisions, including base and percentage rent clauses, security deposits, operating costs, real estate taxes and merchants and promotional fund payments are many times the most important provisions of a lease. As a result, a great deal of lease review time and party negotiation time is spent on the basic economic terms of any retail lease agreement. Whether it is retail space or office, the landlord wants to maximize its income potential so as to secure the most favorable financing for its project, while the tenant seeks the lowest possible rents with the highest amount of market exposure. This session will deal with some of the more critical economic terms of any lease transaction.

I. BASE RENT.

Most retail leases contain base rent provisions which require the tenant to pay a minimum rent for the right to occupy the premises. These base rental payments can be structured in a variety of ways. It may be a negotiated flat amount per year; or a base amount for the initial year with predetermined increases each year thereafter; or a fixed amount with periodic increases based on cost of living increases or other agreed upon criteria; or a monetary sum based on the square footage of the premises. Regardless of the methodology adopted, the lease should be clear in specifying when the payments are due, what grace periods are granted to the tenant for late payments, if any, the right of the tenant to any adjustments or offsets against base rent payments and the collection of sales taxes on such sums.

If the rent is based on the square footage of the premises, the lease should provide a methodology for calculating of the size of the premises. Most retail leases provide for a gross building area computation which does not permit a reduction of space for any elevators, columns, escalators, or mechanical components located within the leased premises. Typically, the square footage is calculated to the exterior of exterior walls and the middle of interior walls. These calculations are typically conducted by the landlord's architect and absent manifest error, are deemed accurate unless somehow challenged by the tenant. Unlike office leases which typically adopt the BOMA Standard and an agreed upon common area factor, there are no established industry criteria for measuring retail lease space.

Most leases will require that payments be made on the first day of the month but allow the tenant a grace period within which to make payment. Depending on the negotiating power of the tenant,

that grace period may be between five and fifteen days. In addition, some national retailers require that the landlord provide written notice of the failure to receive rent on a timely basis. This is due to the fact that most national retailers have computerized payment systems and they may not know if a check was lost in the mail. The lease should also provide for a late payment penalty. This could be a flat fee or some sort of interest factor, or both. Most landlords will not allow any adjustment or offsets to the rental payments. This is due to the fact that the landlord's lender will depend on the cash flow from the rental stream to repay the mortgage and will insist the tenants not have the right to adjust or offset claims against base rent payments.

Depending on the jurisdiction, Florida being one of four in the United States, the payment of base rent may trigger sales tax implications. The Florida Department of Revenue takes a very strict position on what it considers to be rent. If the lease defines any sums due the landlord as "additional rent," the Department of Revenue has taken the position that such amounts are to be included in the sales tax computation. In other words, if operating expenses, insurance, real estate taxes and promotional fund/merchants association dues are deemed to be additional rent pursuant to the lease, then the landlord must collect sales tax on such sums and remit same to the Florida Department of Revenue.

PERCENTAGE RENT.

Unlike in office leases, most retail leases provide that in addition to the base rental payment, the tenant will also pay, on an annual basis, a percentage of sales above a predetermined minimum amount. That minimum amount is usually referred to as the "annual breakpoint". The breakpoint can be a "natural" breakpoint or a negotiated number which differs from the natural breakpoint. The natural breakpoint is arrived at by dividing the annual base rent by an agreed upon percentage-rent rate. These percentage rent rates are established as part of the negotiation and differ based on the type of tenant. For example, most apparel stores will pay percentage rent in the range of three to seven percent. Other speciality's stores may pay a percentage rent rate of anywhere between five and ten percent.

So, to arrive at the annual natural breakpoint, you divide the base annual rental amount (\$100,000.00) by the percentage-rent rate (.06) and determine that the natural breakpoint is \$1,666,666.66. Once the tenant has reached that level of sales during any lease year, the tenant must then pay an additional six percent of every dollar of gross sales collected from sales

originating at the premises during that lease year, as percentage rent to the landlord.

Inherent in the calculation of percentage rent is a proper definition of gross sales originating from the premises and any exclusions from the gross sales figure. Typically, the landlord would like to collect gross sales on all income generated by the premises. In today's world we see more gross sales clauses also including mail order sales and Internet sales which may originate from the premises or which are filled at the premises. The landlord would like the broadest form definition (see attached schedule of "pro-landlord" lease clauses), while the tenant typically seeks to exclude a series of items from its definition of gross sales (see attached schedule of "pro-tenant" lease clauses). Depending on the negotiating strength of the tenant, the tenant will be able to exclude some of its sales from such computation.

To keep the tenant honest, the landlord will typically require that the tenant report its gross sales on a monthly basis and that it provide a certified statement at the end of the year reconciling all of the monthly sales reports. In addition, the landlord will require that it have the right to audit the tenant's financial records to ascertain that the gross sales figure reported by the tenant is accurate. Tenants will typically request that such audit rights be limited to certain periods of time and that once a period has been audited, it may not be re-audited in the future.

The last issue which is often the subject of negotiation in percentage rent clauses is when the percentage rent is actually paid. Some landlords require that the breakpoint be divided by twelve to arrive at a monthly sales breakpoint, and that during any month in which the tenant exceeds that monthly breakpoint number, the tenant remit percentage rent on the overage at the end of that month. The landlord and tenant would then reconcile the number at the close of each lease year. This clearly puts the tenant at a disadvantage in that it may be paying percentage rent during high sales months, (such as the Christmas selling season), when in fact, on an annualized basis, it never achieves the annual breakpoint and no percentage rent will ever be due the landlord. At the other end of the spectrum, many tenant leases require that the tenant not pay any percentage rent until the end of the lease year at which time it will provide the annual statement to the landlord and then remit any percentage rent amounts that are due. This is unfair to the landlord since if the tenant has an exceedingly good year and arrives at the annual breakpoint in the sixth month of the lease year, in essence, the tenant has the use the landlord's percentage rent monies for six months, at no charge. The fairest way to negotiate the payment of percentage rent, is to require that the tenant begin to pay percentage rent during the month that

the breakpoint is achieved and that it pay percentage rent monthly for the balance of that lease year. This would cause the tenant to pay the landlord the excess funds when and as they are received by the Tenant and earned by the Landlord.

III. SECURITY DEPOSITS.

Most retail leases require that the tenant pay a security deposit which can be anywhere from one to three months depending on the creditworthiness of the tenant. The lease should provide that the security deposit is not to be considered an advance payment of rent or to be applied by the tenant to any future rental payments, specially the last month of the term. The lease should also specify the amount of interest to be paid to the tenant, if any. Most retail leases, unless required by statute, will provide that no interest will be earned on the security deposit.

The landlord should have the right to readily access the security deposit in the event the tenant fails to make payments as required under the lease. The tenant should also be required to replenish the deposit upon written demand from the landlord in the case of a partial draw down by the landlord. Some large retail tenants are able to negotiate some form of earn-out of the deposit during the life of the lease. For example, if the tenant has not defaulted during the first twenty-four months of the lease, some or all of the security deposit may be earned-out as rent during the first few months of the third year of the term or some other negotiated period of time. Some tenants are also able to negotiate the placement of a letter of credit as opposed to a cash deposit. This will all depend on the bargaining power of the tenant and the need of the landlord to have that tenant in its property.

Lastly, the condition for repayment of the security deposit to the tenant should be clearly stipulated. Most landlords will insist that they retain the security deposit until the tenant has fully vacated the premises and all monetary reconciliations between the landlord and the tenant have been completed. The landlord should agree that it will refund all sums due to the tenant no later than fifteen to thirty days after the tenant vacates the premises and all financial reconciliations have been completed.

OPERATING COSTS.

Most retail leases require that the tenant reimburse the landlord a proportionate share of the

operating costs of the common areas of the shopping center. These operating expenses are usually referred to as common area maintenance costs and are generally referred to as "CAM". In drafting a pro-landlord lease, they should not be referred to solely as "common area maintenance costs" since some of these charges also include operating expenses for non-common areas. Therefore, recently most leases have begun to refer to these charges as "operating costs". These costs would include all of the operating charges associated with operating the shopping center including security, repairs, insurance, utility charges and all of the other expenses that are normally attributable to the operation of a shopping center. In addition to the actual out of pocket expenses, most operating cost provisions include an administrative fee or a management fee to the landlord which is usually a percentage of the total operating cost of the shopping center.

While the definition of what is included as an operating cost should be drafted broadly, there is case law in some jurisdictions where tenants have been challenging landlords claiming that they are not providing some of the services which are included in the definition of operating costs, and therefore those drafting operating cost provisions should clarify that the delineation of items included in the operating cost definition is merely for example purposes and not necessarily an obligation that the landlord provide those services. Most tenants will seek to exclude a series of issues from the definition of operating costs. (See list of exclusions attached to the pro-tenant lease clause schedule). The reason for these exclusions is that in the last ten years, while sales at most centers have increased in the single digits, if at all, operating cost charges to those tenants have increased between thirty and fifty percent. The operating cost pass through has become a major source of revenue for many landlords and a major source of concern for many tenants.

Most lease clauses will provide that the landlord issue a detailed annual reconciliation, by line item, to all tenants, within sixty to ninety days of the end of each operating year so that the tenant may determine the actual amounts due and reconcile any overpayments or under payments with the landlord. Many national retailers now require that they have the right to audit the landlord's records to verify the accuracy of the amounts being charged. The limitations on those audit rights typically mirror those of the landlord's right to audit the tenant's records for verification of gross sales.

V. REAL ESTATE TAXES

In addition to the payment of Base Rent, Percentage Rent and reimbursement for common area

operating charges, retail leases typically require the tenant to pay real estate and improvement taxes on the premises and to pay a percentage share of the real estate taxes for the shopping center. It is of critical importance to agree upon the definition of the term "Real Estate Taxes". The landlord will generally attempt to include in this definition all ad-valorem and all non-ad-valorem taxes assessed upon the property. This has become a major issue in Florida.

Many retailers will agree to pay real estate taxes only on the ad-valorem portion of the property tax bill and refuse to pay for any special or other assessment which are included in the tax bill. In recent years, many cities and counties have removed from the ad-valorem portion of the tax bill costs and charges that were typically included in such computation, and passed those charges to the non-ad valorem portion of the tax bill, and call them "assessments and fees". These assessments could be for fire services, emergency medical services, police, and other public services which have historically been included in the ad-valorem tax computation. There has been legal challenge to these assessments and the final resolution will lie in the courts. Some of the lower courts have ruled that these assessments are considered taxes, but the Florida Supreme Court has recently failed to hear an appeal which upheld the rights of counties to remove these items from the ad-valorem portion of the tax bill and pass them on as non-ad-valorem assessments. Because of this uncertainty, it is critical that the lease provide a clear definition of real estate taxes.

There is presently a case pending in Broward County where the ad-valorem portion of the real property tax bill was between \$20,000 and \$30,000 while the non-ad-valorem special assessments were \$88,000. Most tenants will argue that they are not responsible for these non-ad-valorem assessments and therefore will refuse to pay them. An improperly drafted definition could be a major source of concern and economic slippage for a landlord. In addition to the above, the definition of taxes should include the landlord's reasonable administrative costs in administering the taxes and also, any and all costs which may be expended by the landlord in contesting and attempting to reduce the real estate tax figure.

Most lenders will require, and most landlords will collect estimated taxes, on a monthly basis, along with the base rent payment. At the end of each tax period, the landlord and the tenant will reconcile the taxes based on the actual tax amounts and the party owing any sums will typically pay the sums in question.

Some large national retailers refuse to pay taxes on a monthly basis but rather agree to pay to the landlord the sums that are due upon presentation of a copy of the tax bill, such sums being remitted no later than at least 15 days prior to the day they are due to the taxing authorities.

VI. MERCHANTS AND PROMOTIONAL FUND PAYMENTS

Early retail leases provided that the landlord had the right to create a merchants association and required all tenants to be members of the merchants association and pay association's dues. The dues would then be used to create a joint marketing and promotional plan to advertise the center and draw customers to the retailers. Many early leases also required that in addition to merchants association's dues, the tenant participate in and pay for certain "tabloids" which were direct marketing mailers sent by the shopping center to their immediate trade area. Retailers were typically required to participate in four to eight tabloids per year.

In recent years the concept of merchant association dues and tabloid publications has mostly come to an end. Today, most retail leases require the tenant to pay funds into a joint promotional fund which is administered by the landlord. The landlord is responsible for the hiring of a promotional or marketing director for the center and that person is responsible for creating the joint marketing plan of the shopping center. The cost and salary of the promotional director and all advertising and media campaigns is paid through the promotional fund.

The amount of the payment varies but typically is based on the square footage of the demised premises. Since most tenants do not have a great deal of confidence in the ability of the promotional program of the center, they either refuse to participate or at the very least require that the amount required to be paid into the promotional fund be capped. Further, most national retailers will require that a minimum percent of all of the other tenants in the shopping center also be required to participate in the promotional fund prior to their being obligated to making any payment to such fund. Payments to the fund are usually increased on an annual basis either by the cost of living or by some pre-determined newspaper advertising line rate increase formula.

Most large tenants, who have individual marketing and promotional programs, do not participate in the promotion fund. This creates a problem for the landlord in meeting any minimum percentage requirements and also causes many of the smaller tenants to object to their being required to participate. The counter-argument to this is that most large national retailers who provide their

own television and media advertising in fact draw shoppers to the center and therefore collectively benefit all of the tenants in the center.

CONCLUSION

While most of the economic issues are negotiated by the real estate people, it is many times the brokers and the lawyers who are responsible for memorializing them in writing. Whether at the letter of intent level or at the lease level, proper drafting is the key to a successful lease execution and a clear understanding of the landlord-tenant relationship for years to come.

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