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Retail Leases in an Office Building: Understanding Each Other

Office landlords understand office leases and retail tenants understand retail leases. But when a retail tenant leases space in an office building, both parties need to step outside of their comfort zones. Most office landlords insist on using their standard form of office lease, with modifications to address retail issues. Because most fundamental leasing concepts are common across all types of leases, this approach is acceptable provided the office landlord can reasonably accommodate the particular concerns of its retail tenants – and vice versa. Below is a sampling of some key issues that each party should anticipate during the lease negotiation process.

Michael J. Meacher
Real Estate Attorney,
Husch Blackwell LLP, Denver

■ **Rent: Structure.** Retail leases typically use a "triple- net" rent structure, meaning that the tenant pays the quoted rental rate plus its share of taxes, insurance and maintenance costs. Although this triple net structure is becoming more common in office leases, the majority of office leases still use a "base year" rent structure. In a typical base year lease, the quoted rental rate includes these operating costs. After the base year (usually the first year of the term), the tenant pays its share of any increases in operating costs over and above the operating costs incurred in the base year. Also common in office leases is the "expense stop" rent structure. An expense stop lease is similar to a base year lease in that the quoted rental rate includes operating costs and the tenant pays its share of increases in operating costs, in this case over and above a pre-determined expense stop. The quoted rental rate of a triple- net lease will be lower than that of a base year or expense stop lease because the latter two already account for base operating costs. There are pros and cons to each structure, but each is simply a mechanism to pass through operating costs to the tenant. Provided a retail tenant is able to identify the effective rental rate across various leasing opportunities, the tenant should focus less on rent structure and more on excluding operating costs that do not benefit its operations. (See Services below.)

■ **Rent: Percentage Rent.** Retail landlords commonly collect a percentage of the tenant's gross revenues in addition to base rent and operating expense pass-throughs. This "percentage rent" is not collected from office tenants, but office landlords should incorporate the concept into their retail leases whenever possible. Percentage rent provisions usually include detailed provisions defining gross revenues and establishing the threshold level of gross revenues over which the landlord is entitled to its percentage. When percentage rent is included, the landlord should require sales reports and the right to review/audit the tenant's records to confirm accurate reporting. Additionally, if percentage rent forms a material part of the total rent, the landlord may require the right to terminate the lease if gross revenues consistently fail to achieve a threshold level. Similarly, a tenant may require a termination right if gross revenues are not meeting its expectations.

■ **Services.** Retail tenants typically will obtain their own electrical, janitorial and trash services and, in many cases, install and maintain a separate HVAC system (thus avoiding "after-hours" HVAC charges that are commonplace for office tenants). In this case, retail tenants should seek to exclude such services from operating costs to avoid subsidizing the office tenants. On the other hand, because many retail spaces use significantly more water and gas than office spaces, a landlord should consider installing submeters or explore other options to fairly apportion these costs to prevent the office tenants from subsidizing the retail tenants.

■ **Permitted Use, Exclusive Use.** For obvious reasons, office landlords can't rely on the standard phrase "general office use" as the permitted use for retail premises. Instead, a specific description of the retail tenant's operations should be used. The permitted use must allow for flexibility in the tenant's business while still allowing the landlord to control the mix of retail tenants in order to maximize gross revenues across the entire retail space. In that same vein, retail tenants should seek exclusive use rights for the core components of their business. Whether the landlord can grant such exclusive rights will depend on the scope of the exclusive rights and the number of affected retail spaces. In an office building with only two or three retail spaces, reasonable exclusives shouldn't pose a problem for the landlord.

■ **Continuous Operation.** Many retail leases require tenants to continuously operate from the premises during specified minimum hours. This is not normally a concern for an office landlord but when dealing with retail tenants, especially where percentage rent is included and/or the retail use is an amenity for the office tenants (e.g., convenience store), it is something the landlord should pursue.

■ **Signage.** For many office tenants, prominent signage is merely a nice perk. But for retail tenants, adequate signage is critical (excepting perhaps "amenity" retailers). Signage specifics should be addressed at the letter of intent stage to avoid unpleasant surprises down the road.

■ **Conclusion.** The foregoing is only a small sample of the issues that can arise when a retail tenant leases space in an office building. Additional issues, such as those related to parking, assignment/subletting, security deposits/lease guarantees, and the construction and insuring of tenant improvements, also deserve consideration as early as possible in the process. Finally, it's worth noting that food and beverage operations come with their own unique set of issues. But all of these issues can be adequately addressed if each party can appreciate the other's concerns, particularly if each party is supported by brokers and legal counsel well-versed in the intricacies of both office and retail leases.