Chapter 1

Computation of Rental Charges and Rent Offsets

Base Rent

The essence of a commercial lease is that the tenant pays the landlord for the right to occupy a particular space for a specific period of time. The most common term for this occupancy charge is *base rent*. Sometimes it is referred to as minimum rent, fixed rent, or rent. The letter of intent or proposal letter will set forth the initial base rent and the method of computing increases. During the preliminary negotiations for the deal, the tenant should be cognizant of the different ways in which these increases can be implemented. The simplest method is that the base rent increases annually by a fixed percentage. For example, “the base rent increases on each anniversary of the rent commencement date by 3%.” Another alternative is that the increases are staggered over a number of years. Thus, the base rent might remain fixed for the first three years, increased by a certain amount for the next four years, and then increased again for the last three years. The first example enables the landlord to obtain rent increases quicker. This may be important for debt service or, if the landlord is a public company, for showing consistent growth in earnings. The latter example gives the tenant some breathing space before it must adjust to higher occupancy costs. Inadequate capitalization is the reason most restaurants fail in the first few years; so if money is projected to be tight in the early years of operation, then the staggered increases might be preferable.

The base rent also might be adjusted based on the increase in the consumer price index (CPI). The CPI method can be either the sole method for computing rent increases or an alternate computation. If it is an alternate computation, then the rent increases are based on the greater of the fixed increases or the increase in the CPI. If the CPI is used, it is essential that the lease establish which index is applicable. The most common indexes are the CPI-U (for all urban consumers) and the CPI-W (for urban wage earners and clerical workers). These two indexes will not necessarily result in the identical level of increase.
For example, according to the Bureau of Labor Statistics website, during calendar year 2014, the CPI-U increased 0.8% while the CPI-W increased 0.03% during the same time period. The CPI-U is a broader measure. Social Security cost-of-living adjustments are based on the CPI-W. If the CPI is used as a method of computing rental increases, it is important to determine the relevant base period. For example, the initial release date for the CPI for January 2015 was February 26, 2015. They are generally six weeks behind before the initial estimates are released. If the tenant’s rent is due to increase in January 2015 based on the increase in the CPI for calendar year 2014, that figure would not be known until February 26, 2015. This would entail a reconciliation of the rent charges. To avoid this result, the parties could agree to use the increase for the period from November 2013 through November 2014, those figures likely being available in December 2014. The lease should also specify that these initial estimates are final, binding, and conclusive since the Bureau of Labor Statistics revises these initial estimates. As with horseshoes and hand grenades, close enough should be good enough.

Some leases use a rent stabilization clause to adjust the base rent. While it can take many forms, the most common version of a rent stabilization clause is that the base rent is increased periodically by the increase in the sum of the base rent and the percentage rent payable by the tenant in a preceding period. This sum is often referred to as “effective rent.” For example, if the base rent in the first lease year was $100,000 and the tenant paid percentage rent in the amount of $20,000 for that first lease year, then the base rent would automatically increase to $120,000 for the second lease year. Sometimes this rent stabilization is an annual adjustment, but it can also be staged (e.g., every third lease year or a one-time increase halfway through the lease term). If base rent is increased periodically rather than annually, the rent stabilization can also be the average effective rent over a period of years or it can exclude some years altogether. Rent stabilization can be used in connection with any of the foregoing methods of increase to maximize the base rent potential.

For option periods beyond the initial lease term, there can also be some additional wrinkles. Some leases provide that base rent for an option period will be based on the so-called “fair market rental value” of the premises at the time the option to renew is exercised. This method is fraught with difficulties. In the authors’ experience, the parties rarely agree upon this value without third-party intervention. The tenant thinks the base rent is too high, and the landlord thinks the base rent is too low. Thus, it is essential that the lease contain a procedure for resolving this difference of opinion. A well-drafted clause will stipulate that if the parties are unable to agree upon the fair market rental value within 30–60 days after receipt by the landlord of the tenant’s exercise of the option to renew, then the parties will submit to some form of binding arbitration. They can invoke the rules of the American Arbitration Association, or they can use a more informal procedure where each party selects an experienced commercial real estate broker or appraiser within the
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area where the shopping center is located. If the latter is chosen, then those two brokers attempt to reach a fair market rental value; if they are unable to do so within 30–60 days, they select a third broker. The third-party broker can resolve this issue in a myriad of ways, so it is important that the precise method be outlined in the lease. The third-party broker could be given discretion to determine an independent fair market rental value, and that determination could be binding on the parties. The third-party broker could be required to invoke the “baseball” option where it must choose one or the other of the two original appraisals of the fair market rental value. The third-party broker could be required to eliminate any original estimates that deviate by more than 5%, for example, from its own appraisal and then average the remaining appraisal with its own. The parties are limited only by their own creativity. The key point is that the lease should not simply say “fair market rental value” without establishing some mechanism for determination.

Percentage Rent

There are numerous other rental charges of which the tenant must be aware, including percentage rent, taxes, common area expenses, utilities, and pest control. An exhaustive treatment of these charges is beyond the scope of this book, but the authors would refer the reader to their prior publication mentioned earlier, which deals with these issues in great detail. Still, a cursory review is in order as it pertains to restaurants.

In many commercial retail leases, the tenant will be required to pay percentage rent. The tenant is obligated to pay the landlord, as an additional form of rent, a portion of its gross sales generated at the restaurant. Usually the percentage rent is computed over a base figure called the sales breakpoint. A natural sales breakpoint is computed by dividing the base rent by the percentage rent rate. For example, if the percentage rent rate is 5% and the base rent is $50,000, then the natural sales breakpoint would be $1,000,000. The tenant would pay 5% of its annual gross sales in excess of $1,000,000 to the landlord as percentage rent. An artificial or unnatural breakpoint is one that is determined by some other method devised by the parties. The artificial breakpoint could be lower or higher than the natural breakpoint. There could also be a stepped-up artificial breakpoint where the percentage rent rate is one figure between two breakpoints and the percentage rent rate increases or decreases for sales over that upper breakpoint. For example, “5% of annual sales between $1,000,000 and $2,000,000 and 6% of annual sales above $2,000,000.” It is important that the tenant recognize how the breakpoint is computed in the lease so that it can budget accordingly for this additional rental payment. The percentage rent rate can be an important factor too in the tenant’s rental charges. For food court tenants, the percentage rent rate can vary from 10% to 15% of annual sales, while for fast casual and table-service restaurants, the percentage rent rate often ranges between
5% and 7%. The discrepancy is usually attributable to the simple fact that fast casual and table-service restaurants have higher operating expenses, such as labor and input costs for food and beverages.

The tenant should also confirm that the percentage rent is computed on “adjusted gross sales” rather than “gross sales.” Most leases contain some boilerplate exclusions from gross sales, such as sales taxes, exchanges of merchandise between stores, and refunds to customers. The percentage rent should be computed on this adjusted figure since that is the monetary amount actually retained by the tenant from sales. Our focus will be limited to identifying exclusions that are either unique or significant to restaurants. The most common exclusion for restaurants is tips paid by customers to the tenant’s employees. As long as this money is retained by the employee, the landlord will agree to this exclusion. However, some fine dining restaurants pay a salary to their experienced wait staff and retain the tips themselves. In that case, these tips should not be excluded since that is profit to the restaurant operator.

A variety of tipping that has gained some popularity on both the East Coast and West Coast is what is known as “revenue sharing.” Many restaurants have found it increasingly difficult to retain the kitchen staff, especially cooks and chefs. When restaurants are busy, the servers make more money but the line staff does not. To remedy this situation, some restaurants have added a “food administrative” charge of between 3% and 5% to the price of the meal and beverages. This amount is paid directly to the kitchen staff so that they share in the bounty. From the landlord’s point of view, it could be argued that this is nothing more than a wage and therefore a cost of doing business since the charge is mandatory. Thus, the landlord would not want to exclude it from gross sales. From the restaurateur’s perspective, it is another form of tipping which, as long as it is paid to the kitchen staff, should be excluded, especially if tipping the service staff is excluded. As with the case of tipping, the compromise may be to exclude it to the extent the charge is paid to the kitchen staff.

Many upscale restaurants also offer complimentary or discounted meals and beverages to certain customers. These exclusions are often capped at 2%–3% per year. If the meal is discounted, then the lease should be clear about whether the cost of the entire meal is excluded or only the portion is discounted. If a customer brings in a coupon and gets 20% off his entrée, then the remainder of the bill should be included as a sale. To avoid tracking all of these discounts, the aforementioned cap on overall discounted sales per year is often implemented. Both the landlord and the tenant have an interest in driving business to the restaurant, and a discounted meal or a “buy one, get one free” meal can be a very effective form of advertising.

Fees paid to credit card companies for processing transactions pose a sticky problem. From the landlord’s perspective, these fees, which can range from 1%–5%, are a cost of doing business and should not be excluded. However, given the significant cost that tenants
must absorb in paying these fees, the tenants are often adamant that they be excluded. They argue that many sales would not occur if the customer had to pay in cash. With the advent of mobile payment, this problem is likely to loom larger in the future. If the point becomes a deal breaker, then an annual percentage cap of 1%–2% is often the solution.

Some tenants want to exclude the cost of employee meals from the gross sales calculation. To the landlord, this is another form of compensation, i.e., wages, and would object to its exclusion, especially if the employee had to pay for some portion of the meal. As a practical matter, the cost of employee meals is often minimal. Table-service restaurants may want to exclude costs incurred with respect to valet parking. Some landlords may consider this a cost of doing business as well and are unwilling to exclude it from gross sales. The sale of gift certificates is usually excluded from gross sales as long as the redemption of any gift certificate, whether purchased at the restaurant or elsewhere, is included in gross sales. Bad debts are another exclusion that is often vigorously negotiated. The tenant wants to exclude all bad debts from gross sales since it never received the money from the fraudulent credit card charge. The landlord, however, does not want to subsidize bad credit practices. As with many of the other exclusions, a common ground is often an annual percentage cap on these bad debts. However, if the landlord does agree to exclude any portion of bad debts from the gross sales, then any subsequent recovery of those bad debts should later be added back into gross sales. Many restaurants, whether fast-food, fast casual, or table service, offer catering services. The lease should clearly address whether these sales are included in gross sales. Increasingly popular are food delivery services, such as Uber Eats where a third party delivers food prepared by a restaurant. In that case, the tenant should be permitted to exclude the amount of the delivery charges paid to the third party. If the landlord will not permit an unlimited exclusion of these delivery charges, then the parties should agree on a suitable cap that can be excluded on an annual basis.

The tenant may also want to exclude sale of obsolete or used restaurant equipment since its primary business is selling food and beverages. A few enterprising restaurant operators provide third-party advertising space on its menu. Presumably this would be included in gross sales unless specifically excluded. Some tenants may have vending machines on their premises. If operated by the tenant, then all of these sales would ordinarily be included in gross sales. However, if a third-party vendor operates these machines, then at least the commissions paid by the vendor to the tenant should be included in gross sales.

The advent of e-commerce sales at shopping centers has and will continue to affect restaurant leases. Many restaurants and ridesharing companies offer to deliver to the consumer’s home or business meals that are prepared at the restaurant. As with internet sales at brick-and-mortar retailers, the landlord will assert that since the meal originated at the restaurant, it should capture the sale for percentage rent purposes. In most cases, the proceeds from these e-commerce sales go directly to the restaurant that prepared the food, which further bolsters the landlord’s case that the sale occurred at the restaurant.
The restaurant may assert that the sale would not have occurred if it was not delivered to the consumer’s home or business and therefore it was made simply as a convenience to the customer. The customer did not show up at the shopping center, so no sale would have been made but for the delivery service. The landlord will counter that these delivery sales are no different in form and substance from a carryout order where a customer might call in by phone and pick up the meal at the restaurant. Complicating matters would be where the customer uses a mobile app to order the meal and then picks it up at the shopping center. Is that different from ordering by phone? How does one assess the motive of the customer? Was it an impulse buy when the customer was at the shopping center, or did he intentionally order it off-site and simply pick it up on the way to another destination, such as an airport or on the way to a business appointment? The pick-up case seems stronger for the landlord since the customer had to make the effort to show up. In any event, it is clear that there are no simple solutions to the treatment of internet sales in the restaurant sector, and these issues are likely to multiply in the years ahead as e-commerce becomes a major, if not primary, means of conducting transactions between customers and shopping-center based businesses, especially in major metropolitan areas.

In some cases, delivery sales are a “loss leader” to encourage customers to build loyalty with a restaurant. The margins are very thin as opposed to a customer who consumes at the restaurant, so the restaurant may attempt to exclude them entirely from gross sales. Another vexing question may arise where a national chain has its own web-based application and orders are made to a central clearinghouse and then transmitted to the restaurant. The parties may have to investigate whether the chain allocates these e-commerce sales to the local restaurant. As with many other exclusions, a cap on such exclusions may satisfy both parties. However, the landlord would still want the restaurant to report all of these delivery sales as gross sales at the restaurant while allowing the tenant to exclude those orders generated from the internet, or some amount thereof, for purposes of paying percentage rent. Even if the tenant is required to include in gross sales the entire sale price of the meal, the tenant should exclude third-party delivery charges from the sale price since that is no different than paying UPS or FedEx to deliver a package of soft goods to the customer’s home.

A unique twist on the delivery-to-consumer concept is where a third-party delivery service takes the order on its phone lines or web-based application and transmits the order to the restaurant; the restaurant prepares the food; and the delivery service delivers the food, bills the consumer, and then pays a percentage of the proceeds to the restaurant. The restaurant should provide in its lease that in such transactions, only the amount actually paid to the restaurant is included in gross sales for percentage rent purposes since it is to some extent subsidizing the sale.

As with most issues on a lease, exclusions from gross sales often revolve around the negotiating strength of the parties. The intent here is to make the parties cognizant of
certain exclusions that may be applicable for restaurant tenants and of the dichotomy between reporting a sale and paying on a sale. To maximize the rental value of its real estate, the landlord will want to include as much as possible in gross sales so that it can advertise that the shopping center does “x” sales per square foot even if it does not collect percentage rent on some of those sales.

**Ancillary Lease Charges**

In addition to base rent and percentage rent, the tenant will often be required to reimburse the landlord for some share of the real estate taxes, common area costs, and insurance premiums for the shopping center. While these charges are not unique to restaurants, they can be significant outlays and must be factored into the tenant’s analysis of the total occupancy costs the tenant must pay for leasing the premises. The most prevalent form of computation for these charges is a “true” pro rata charge where the tenant’s share of these expenses is determined by dividing the square footage of the premises by the gross leasable area of the shopping center and then multiplying that percentage by the total expenses for a particular charge. In this case, if the tenant occupied 1,000 square feet and the gross leasable area of the shopping center was 100,000 square feet, then the tenant’s share of the tax bill, for instance, would be 1%. A “modified” pro rata charge often excludes certain tenant spaces from the gross leasable area of the shopping center (e.g., anchor stores or separately assessed parcels) and determines the tenant’s share not on the basis of the gross leasable area of the shopping center, but on the basis of the leased or occupied area of the shopping center. This can be a significant difference. Let’s use the above example but assume that 80% of the gross leasable area of the shopping center is leased and open (80,000 square feet). Using the modified pro rata calculation, the tenant’s pro rata share would be 1.25%. Over the course of a 10- to 20-year lease, this can be a substantial increase in expenses. Going one step further, a tenant with significant leverage may be able to negotiate a first-year cap on these expenses or an annual cap on increases based on a fixed percentage or on the change in the CPI.

Some landlords eschew the pro rata computation for all or certain charges and instead establish a fixed amount for the first year and then base annual increases on a specified percentage. For example, “the common area charge for the first lease year shall be $5 per square foot of floor area in the premises and increase annually on the first day of each subsequent lease year by 5%.” This method is utilized more often for common area charges since the landlord has more control over those expenses than it does taxes or insurance. However, it can be used for any charge if that is the agreement of the parties. The fixed charge does provide certainty and eliminates disputes and audits. At the same time, it may not reflect the actual increases in expenses. The parties must balance the certainty of the
charge against the risk that the charge may be greater or less than the actual expenses. A modified version of the fixed charge is to establish a base amount for the first year and stipulate that the tenant pay increases over that base amount. Before the tenant gets too excited and thinks it has wrung a valuable concession from the landlord, it should be noted that this base amount is usually already rolled into the base rent.

Some states and municipalities impose sales taxes on rent or assess occupancy taxes on rent. The tenant should be aware of these taxes since they may be passed through to the tenant. These taxes are over and above ad valorem property taxes for the shopping center. Most often the landlord is the “collection agency” for the taxing authority so that these taxes will be invoiced by the landlord. For a tenant with strong negotiating power, it may be able to offset these taxes against their percentage rent obligations under the lease or have these taxes added to the sales breakpoint over which they pay percentage rent.

Utilities and HVAC Charges

The lease should also clarify who provides utility services to the premises and who pays for such services. In many instances, the tenant will obtain utility services directly from the utility company and will pay for its consumption, utility deposits, connection fees, and meter fees directly to the utility. If utilities are interrupted, the tenant will contact the utility company directly to restore them. At some shopping centers, some or all utilities are included in common area costs. If this is the case, the tenant should determine whether increases in utility charges are subject to an overall negotiated cap on increases in common area costs or if they are excluded from that cap. For a lease with a cap, it would not be unusual for a lease to provide that “common area costs will not increase more than 5% per annum, exclusive of utilities.”

Too many leases and lease reviewers overlook or gloss over the sections of the lease that pertain to utilities; this is a major mistake since the consumption of utilities will be a major expense for a restaurant. It is crucial that the tenant understand who installs and maintains the utility lines; whether the utility is provided by the utility company or the landlord; and, if provided by the landlord, how the tenant’s consumption is calculated. If the restaurant space is metered directly, the tenant should determine whether the existing utility lines are adequate or must be upgraded. If new lines are necessary, the tenant should determine whether the tenant or the utility company will install them. In some cases, the landlord may install and charge the tenant back for these installation costs. From the restaurant’s perspective, direct metering by the utility company is the preferred approach since the tenant can monitor and control its individual consumption as opposed to being part of a pool with other tenants where the engineering formulas for allocation require the expertise of an electrical engineer to decipher. A simple question to ask is who the tenant
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calls if, for example, its electricity or gas service goes out. If it cannot be clearly ascertained from the lease language, then the tenant should insist on more clarification in the lease.

In some jurisdictions, the landlord may be permitted to purchase utilities (e.g., electricity, water, or gas) at a wholesale rate and resell them to the tenants at a retail rate. Often this charge includes an administrative fee for billing and may include a facilities upcharge to reimburse the landlord for maintenance of utility lines outside the premises. The tenant should clearly understand the components of any utility charge that it must obtain from the landlord. Some tenants object to the landlord manufacturing a profit center out of utilities, but unless the tenant has strong negotiating power, it is a losing battle for the tenants; the landlord often has a significant investment in the utility infrastructure at the shopping center and wants a return on it. However, those tenants with substantial bargaining power may be able to negotiate the elimination of these administrative fees, access fees, fire detection service charges, and similar fees. If the lease does not provide otherwise, the tenant should request that the charge not exceed what the tenant could have obtained from the utility company if the tenant had obtained service directly from the utility company. If the landlord accommodates this request, the landlord may draw a distinction between the “rate” the tenant could have obtained and the “cost” the landlord must pay. Due to natural or human-made disasters, utility costs could spike temporarily and the landlord would want the right to pass those temporary surcharges through to the tenants. If the landlord is supplying a utility to the tenant, the lease should specify whether the charge to the tenant is based on a meter reading or an estimate of consumption based on load calculations.

Restaurants are heavy users of utilities, especially electricity, water, and gas, so it is essential that the tenant understand how and what they are being billed for. If the tenant must purchase utility service directly from the landlord, the tenant should inquire whether applicable law or utility company regulations permits installation of a test meter or check meter to verify the landlord’s calculation of the charge. This test meter is run over a period of time (e.g., 30 days) on a periodic basis so that the tenant can compare its consumption as shown on the check meter against the landlord’s determination. As long as the landlord approves of the criteria for the check meter, the check meter reading is conclusive.

In addition, the tenant may request the right to have the landlord’s books and records for utilities audited by a qualified engineer to determine whether the charge was calculated appropriately. Some landlords use models to determine estimated consumption, which may not reflect actual usage. These estimated charges may not be “trued up” for years. In cases where the model understates the cost of consumption, the tenant could be in for an unpleasant surprise and find itself liable for substantial arrearages. To avoid this, the tenant should attempt to add a clause that prevents any undercharges from being billed within a certain time period after the end of the calendar year in which the charge was incurred (e.g., 12–24 months). If the restaurant is an “endcap” or a freestanding building,
the landlord may want the tenant to contract directly with the utility companies for service since the demand loads of the restaurant may exceed the capacity of the utilities that the landlord’s system could provide.

Most of the above-mentioned discussion applies to HVAC charges as well. The HVAC charge is more prevalent in the enclosed mall setting. The landlord may operate a central plant for the entire shopping center or within particular zones of the enclosed mall. The charge is generally based on either an engineering formula set forth within the lease or a pass-through of actual costs plus an administrative fee. Given that most restaurant tenants will not have the expertise to evaluate the computation of the HVAC charge or be willing to pay for outside consultants, it is not uncommon for the restaurant operator to ask for either a fixed first-year charge or an overall cap on annual increases. After the first year of operation, the landlord and tenant should have adequate information upon which to project future charges.

The tenant should understand all components of the HVAC charge. It generally includes the cost of utility service, which can be based on bulk or retail costs, projected maintenance costs of the system, amortization of the initial purchase or major investments in the central plant system, and a special load calculation for heavy users, such as restaurants. Restaurant ovens can generate a great deal of heat compared with a shoe store, so the calculation may allow the landlord to upcharge the restaurant for excessive load. It may also adjust the charge based on additional hours of operation since many restaurants remain open past normal mall hours. Some restaurateurs located within enclosed malls may find it more cost effective or more convenient to install their own HVAC units for their operations. That way, the tenant can control the temperature within the premises at all times, ensure adequate cooling capacity even during peak hours or hot weather conditions, and avoid surcharges assessed by the landlord for operating beyond the mall standard hours. For a tenant with strong leverage, the landlord may pay for the cost of the HVAC unit by installing the unit itself or paying a construction allowance to the tenant to defray the cost. Of course, if the tenant operates its own HVAC unit, it generally bears the risk of repair, maintenance, and replacement.

**Unique Charges for Pad Deals**

A few issues may be unique to pad deals. Since the building constructed on the pad is generally not physically connected to another structure, the pad tenant may be able to obtain a separate tax parcel for the pad. In this case, the tenant would pay the taxing authority directly for all property taxes assessed for the land and the improvements on the pad. If the pad is not initially treated as a separate tax parcel, the lease should specify whether the landlord or the tenant will pursue separate assessment and at whose expense. Until
such time as the separate assessment is obtained, the tenant pays its share of the property taxes the same way the inline tenants pay. If a separate assessment is obtained, the tenant should be required to provide the landlord with proof of payment of each installment of taxes within a reasonable period of time after the due date. The landlord does not want to find that a tax lien has been filed or that a tax sale is imminent because the tenant did not pay the property taxes when due. Some taxing authorities will tax the improvements on the pad separately but not the land underneath the pad. In this case, the tenant would pay all of the taxes attributable to the improvements at the assessed amount on the tax bill and a pro rata share of the taxes for the land based on the ratio of the acreage of the pad to the acreage of the larger tax parcel.

Additionally, if the pad has its own dedicated parking areas, the tenant may not be obligated to pay the landlord for any common area expenses other than a “ring road” maintenance fee. In this case, the tenant would be responsible for the maintenance of the parking spaces and landscaping on the pad at its expense; the landlord would not have any maintenance obligations in this regard. However, since ingress to and egress from the pad uses the access points from the rest of the shopping center property, the tenant would be expected to contribute toward these maintenance costs via a ring road or comparable fee. This is often a fixed charge with annual increases since it is difficult to separate these expenses from the other common area costs. Even if the tenant does not maintain the parking on its pad, at the very least, the pad tenant’s common area costs should be limited to exterior common area costs so that the tenant is not subsidizing the cost of, say, HVAC service provided to the shopping center.

The most important point in this discussion of computing ancillary charges under the lease is that the tenant must clearly understand how these charges are determined. Many letters of intent or deal proposal letters simply say “pro rata” without defining what that means. If the landlord quotes an estimate for these charges, the tenant must understand how that estimate was determined. The tenant may want to request evidence of past charges over a period of years so that it can gauge the accuracy of the landlord’s estimate. Otherwise, it could face an unpleasant surprise when it receives the first invoice or a year-end reconciliation statement.

Rent Abatements, Offsets, and Termination Clauses

From the landlord’s perspective, the cardinal rule of commercial retail leases is that the rental stream is sacrosanct. The investors in the shopping center rely on the income generated by the rent to provide an expected rate of return from their initial capital investment. In addition, this rental income is often pledged as security to repay the debt service on any mortgage encumbering the shopping center. If the shopping center is owned by a publicly
traded real estate investment trust, then Wall Street investors and analysts project future income streams based on the rents set forth in the leases. Furthermore, the landlord is not an ensurer of the tenant’s success. It has provided a space from which the tenant can operate its business, as well as common area amenities. It cannot guarantee that the tenant’s business will never be disrupted. As a result, landlord-oriented leases explicitly state that the tenant has no right to abate rent for any reason.

Of course, the tenant views matters differently. At the very least, it will expect that the landlord will not act or fail to act in any manner that interferes with the tenant’s ability to operate its business from the premises. The tenant may seek some form of rent abatement if a disruption to its business occurs that is within the control of the landlord. Not all tenants will have the bargaining power to negotiate these concessions from the landlord. For those that do, there are some basic guidelines to consider.

Some tenants ask for rent abatement if utilities to their premises are interrupted. Under only two circumstances will a sophisticated landlord agree to this. The first is when the utility service was directly supplied by the landlord. Some landlords purchase utilities from a utility company at a wholesale rate and then redistribute the utility to the tenant at a retail rate. In this sense, the landlord acts as the utility company. If in the lease the landlord has contracted with the tenant to provide a utility to the premises but fails to do so, this is a breach of the lease. An equitable remedy may be to grant an abatement of rent. This remedy may forestall an expensive lawsuit as to whether the landlord breached the lease or constructively evicted the tenant. The landlord may create an exception for acts of force majeure, such as a flood, a hurricane, a tornado, or another act of God or similar events that are reasonably contemplated to be beyond the reasonable control of the landlord.

The other circumstance where rent abatement may be warranted is if the utility interruption is caused by the negligence, intentional misconduct, or breach of the lease by the landlord. Under this circumstance, there is some direct culpability on the part of the landlord for the disruption to the tenant’s business. For example, if the landlord or its agents negligently cut a utility line, shutting off electricity to the premises for a sufficient period of time that the tenant could not operate, then some form of rent abatement may be warranted.

In any case of interruption to utilities, the landlord generally requires a material disruption to the tenant’s operation before it will agree to abate rent. If the gas service is interrupted for an hour and the tenant cannot use its ovens during that period of time, the landlord is unlikely to abate rent even though the tenant may have lost its lunch business for the day. Furthermore, the landlord does not want to be in the position of abating rent for an entire day based on a temporary disruption or, even worse, prorating the rent on an hourly basis. Most landlords will require the disruption to be so severe that the tenant is unable to open for business for at least one business day, if not more. Tenants will be reluctant to close the business entirely if there is some opportunity to salvage sales for that
day. For this reason, closing the restaurant entirely for a period of time until the utilities are restored is some proof that the disruption was material. Some landlords will agree to abate the rent retroactively while others may insist that the abatement apply prospectively.

Any discussion of rent abatement must define what rent is being abated. It could be all or some portion of the base rent or base rent and ancillary rent (e.g., taxes, insurance, common area expenses, and utilities). Alternatively, the tenant could be permitted to pay percentage rent for those days of utility interruption where it operated only a part of the day. If the landlord is adamant that it will not abate rent for a utility interruption or insists that it will agree to an abatement only if the tenant is closed for a substantial period of time (e.g., one week or more), then the tenant can protect itself by obtaining business income insurance. Depending on the terms of the policy, the tenant is reimbursed for its lost revenues, thereby ensuring that it has sufficient funds to pay its rental charges under the lease. Some landlords will permit rent abatement only to the extent not covered by the tenant's business income insurance. Conversely, the landlord can protect its rental stream by obtaining rent loss insurance so that it is able to pay its debt service notwithstanding the loss of income from the utility interruption.

A casualty involving the restaurant or the shopping center may also give rise to rent abatement. If lightning strikes the restaurant and the building burns down, then most leases will abate the rent entirely (or at least that portion of the rent not reimbursed by insurance) until the earlier of the date the landlord (or tenant, as the case may be) rebuilds the premises or after a specified number of days from the date of the casualty. Some leases provide that tenants must continue to pay taxes notwithstanding any casualty on the theory that neither side wants the property to be foreclosed upon at a tax sale.

The more difficult case is where only a portion of the premises is damaged. For example, a broken water pipe may flood part of the restaurant, but if that portion can be closed off and the remainder can operate in a reasonable manner, taking into consideration safety and health concerns, the rent may not be abated entirely. Instead, it may be abated based on the square footage damaged or on the disruption to the tenant's business. Of course, abating rent based on square footage can have pitfalls. The kitchen might be 10% of the square footage of the restaurant, but if that portion is inoperable due to the casualty, then, effectively, the tenant cannot operate. An abatement of 10% would be wholly disproportionate to the loss actually suffered by the tenant. To address this situation, the tenant would want rent abated on an equitable basis to the extent the casualty impaired its ability to operate. While “equity” is an elastic concept, it is frequently used in leases to address these types of situations. Often the parties will look at comparable sales (e.g., the average of sales for the week or month immediately before the casualty) for the measure of damages.

The rent abatement clause should also address the situation where the restaurant is not damaged but other portions of the shopping center are. If a wing of a shopping center is
closed due to a casualty, such as fire or flood, the main means of access to the restaurant might be impaired or eliminated. If the restaurant is part of a vibrant entertainment component with theatres and other restaurants and a substantial portion of that component is closed, then the tenant would expect some abatement of rent until the area reopens. Most customers do not want to walk past construction trailers and scaffolding to go to a restaurant. The number of possibilities is too numerous to contemplate in this discussion. However, it is a contingency that every restaurant tenant should consider in its lease negotiations. An abatement based solely on physical damage to the restaurant may leave the restaurant in the unenviable situation of paying rent on a space that is functionally inoperable.

Similar concerns apply to a condemnation or taking of all or part of the premises or shopping center. Obviously if the entire premises or shopping center is taken by eminent domain, then the lease will terminate and there will be no further rental obligations due. However, if a portion of the premises is taken or a portion of the shopping center is taken, then a determination must be made as to what portion, if any, of the rent should abate. With respect to a taking of a portion of the premises, it will generally be based on the loss of square footage or the loss of utility or fair market value of the portion taken. The lease should address when the rent abates. Does the abatement commence when the taking actually occurs, or does it abate when the parties exercise any right to terminate the lease based on the degree of the taking? Unlike an abatement of rent for a casualty, an abatement of rent for a condemnation will usually be permanent for the remainder of the lease term. The main exception would be if there is a temporary taking or if the area taken was replaced, such as replacing parking that was taken with parking that is contiguous or comparable. For most food court and inline tenants, these questions are more theoretical than real.

As a practical matter, the outlot on the periphery of the shopping center is most likely to be impacted by a taking of its premises. The taking authority may need a portion of the outlot premises for road widening, installation of traffic signals, utility relocation, or entrances to the shopping center. Often it is not a physical taking of the building but rather a taking of parking or access points that are material to the outlot occupant. For this reason, the restaurant on the outlot should address these types of takings as well so that the tenant can abate rent. It can be couched in terms of a “material” taking or if parking is reduced below a certain number of spaces or if the taking affects a protected zone defined in the lease. By way of example, the compensation for reconstruction of curb cuts and replacement of landscaping may pale in comparison to the loss of key parking spaces directly in front of the restaurant. Another means of addressing these takings from the tenant’s perspective is to add lease language that a taking is material if it impacts the tenant’s business as reasonably determined by the tenant. In some situations, the landlord will not provide any abatement of rent if the outlot tenant is reimbursed for the loss of
value by the taking authority. The landlord does not want the tenant to “double dip” by receiving both rent abatement and an award that presumably compensates the tenant for the damage that triggered the rent abatement.

Closely related to abatement of rent is the concept of rent offsets. Often these terms are used loosely in a lease, but they represent two different issues. An abatement occurs when the tenant’s obligation to pay full rent is reduced. In other words, a condition occurs that triggers a reduction in rent. The tenant is not in default for not paying the full rent because a lower rent becomes the contractual rent for that period of time. As long as the tenant is paying the contractual rent, it will not be in default for failure to pay the full rent. Under an offset, the full rent is due but the tenant is owed money by the landlord, which the lease specifically permits the tenant to credit against the full rental payment.

Most leases provide that there is no right to offset against rent unless expressly stated in the lease. A tenant should never unilaterally offset moneys owed by the landlord to the tenant against the rent stated in the lease unless the landlord specifically consents to such arrangement or unless the lease explicitly allowed the offset. Since the covenant to pay rent is often set forth in a lease as a separate and distinct covenant by the tenant, the tenant could put its leasehold at risk by withholding a portion of the rent from its payment to the landlord. Usually the tenant will be limited to its remedies at law or in equity, which means going to court.

The two most frequent situations where a tenant will request a right to offset are in its exercise of self-help remedies under the lease and reimbursement for an unpaid construction allowance. Landlords are very reluctant to grant tenants the right to perform an obligation of the landlord and to allow the tenant to offset those expenses against the rental charges otherwise due as discussed above. For those select tenants able to wring this concession out of their landlord, several limitations typically apply. First, the landlord will require the tenant to provide ample prior written notice of the failure of the landlord to perform a specific lease obligation and an adequate opportunity to rectify the failure. Most landlord leases will provide that the landlord be given a minimum of 30 days from receipt of written notice within which to perform the landlord obligation or such additional time as is reasonably required provided the landlord promptly commences to cure and diligently pursues the same to completion. The tenant may consider limiting the period of time within which the landlord may cure to a specific amount of time, such as 90 days before the tenant can intervene. Landlords often limit the ability of the tenant to “cure” or perform the landlord’s obligations to repairs and maintenance within the premises, such as to a leaky roof, but as with most issues under a lease, this can be amplified to cover areas, such as maintenance of common areas or even payment of the landlord’s taxes or debt service in rare instances. If there are numerous potholes where the restaurant customers park, this may impact the traffic to the restaurant, so the tenant may insist on the ability to repair if the landlord does not. The landlord may be amenable to a right of self-help
within some specified critical zone in the common areas as opposed to a blanket right to make repairs anywhere in the shopping center.

Even if the tenant has the absolute right under the lease to perform a particular obligation of the landlord, the right to offset must be specifically permitted by the lease. The landlord may limit this right of offset by providing that it may in good faith challenge whether the obligation was in fact the landlord’s, whether the exercise of the right of self-help was necessary under the circumstances, and whether the cost was reasonable. The tenant should require the landlord to make these first two challenges during the initial 30-day period rather than allowing the tenant to exercise its self-help rights before questioning the tenant’s right to do so. These limitations severely restrict the tenant’s right to offset, in which case the tenant’s only effective remedy is to seek judicial relief. Some landlords may go one step further and provide that there is no right to offset until the tenant has obtained a final, nonappealable judgment in its favor and the landlord has failed to pay such judgment within 30 days thereafter. Of course, tenants should recognize that this remedy is not much better than being required to take the landlord to court before exercising self-help rights. Rent offsets are anathema to landlords, and they want to make it as difficult as possible for the tenant to invoke. As a result, most tenants will trigger a right of self-help and offset only in extreme situations.

For an unpaid construction allowance, a tenant may be more aggressive in insisting on a right of offset. After all, the landlord promised to pay the tenant a certain sum of money toward the leasehold improvements as an inducement to enter into the lease. This is especially true for restaurants, where the construction costs are usually much higher than for the ordinary retail merchant space. The tenant may be relying on the landlord to fund its construction through installment payments or in a lump sum. The work will not get done on time or sometimes at all if the contractors are not paid when due. Liens may get filed on the shopping center, and the tenant may be placed in default for the imposition of these liens. Contractors may walk off the job until paid. The tenant may have pledged the construction allowance to its lender in order to secure funds to complete the tenant’s cost of the leasehold improvements. While landlords often view these construction allowances as reimbursements to the tenant after the tenant has paid for the work in place, as a practical matter, many restaurants rely on this source of funds to replenish funds so that they can pay the next construction draw or, in the case where the allowance is in one lump sum, restore its operating capital.

The tenant should confirm that the payment terms in the lease are consistent with its payment to its contractors. Most landlords will want between 10 and 30 days within which to make the payment to the tenant after submission of the required documentation. If the landlord does not pay on time, then the tenant may be required to provide written notice of the failure to pay, in which case the right to offset would be triggered if the landlord did not pay within a shorter period of time after receipt of such notice. The tenant may
also want to protect itself by requiring the landlord to pay interest on any late payments since the tenant was deprived of its use of that money. The basis for the interest calculation should be expressly set forth in the lease, such as 8% per annum, or 2% per annum over the prime rate of interest then charged by a specific bank or as announced in *The Wall Street Journal* or comparable publication.

It cannot be overemphasized that the right to offset for the unpaid allowance must be expressly permitted by the lease. The tenant cannot just assume that it is unfair for the landlord to hold onto the money while the tenant is required to fork over the rental payments. As noted previously, the lease will generally provide that the obligation to pay rent is independent of all other lease obligations. It would be small consolation for the tenant to prevail in a court of law for breach of contract against the landlord but lose its lease because it asserted a right that was not allowed by the lease. Even if tenant has the right to offset, it may take an undue length of time to reimburse itself, which in turn impacts the tenant's cash flow. For example, if the landlord has agreed to pay a construction allowance in the amount of $1,000,000 and the tenant's annual rent is $300,000, it will take the tenant longer than three years to recoup the amount of the allowance. If the tenant is concerned about timely payment of the construction allowance, it could require the allowance to be paid into an escrow account with a third party, such as a title company. The payout of the escrowed amounts would mirror the lease requirements so that the tenant would always be assured of timely payments. Alternatively, it could require the landlord to secure the landlord's obligation to pay with a letter of credit upon which the tenant could draw down if payments were not made as required.

**Co-Tenancy**

A co-tenancy clause is a provision pursuant to which the tenant is permitted to pay a reduced rent unless some combination of certain occupants and a specified percentage of the gross leasable area of the shopping center is open for business. The tenant has bargained for a contractual rent based on certain expectations of occupancy at the shopping center. If these levels are not met, then the tenant's projections of sales may be wholly disproportionate to the total rental charges payable under the lease. The reduced rent can cushion the blow resulting from these lost sales. Additionally, the co-tenancy may be an inducement for the tenant to open before the desired level of co-tenancy is achieved, such as in the case of a new shopping center. It may also serve as a motivation for the landlord to achieve the occupancy level or else face a loss of rental income. In general, co-tenancy clauses fall into one of two categories: opening co-tenancies and operating co-tenancies.

An opening co-tenancy is generally granted only when a new shopping center is being constructed or a major redevelopment or renovation of an existing shopping center is