

NAVIGATING THE AMAZON: THE IMPACT OF ECOMMERCE ON RETAIL LEASE STRATEGIES

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Every real estate industry headline today seems to trumpet the decline of retail leasing and the advent of ecommerce: the so-called “Amazon Effect”.¹ One recent article recounts the impact of Amazon on traditional retailers such as Walmart and concludes that:

“It is apparent the Amazon Effect has left America with far more storefronts than needed. Stand-alone stores are being shuttered, with no alternative use for most buildings. Malls and shopping centers go begging as traffic drops, tenants leave, lease rates collapse and the facilities end up wholly or nearly empty. This may mean you don't want to invest in retail real estate REITs. But it also may mean that neighborhoods, and sometimes entire towns, will be impacted as these empty buildings reduce interest in housing and push down residential prices.”²

Amazon has changed the way consumers shop. Shopping center owners have reacted by repositioning their properties in a variety of ways. Some traditional malls are being used as back offices.³ or medical facilities⁴ Other large

¹Amazon and high rents are killing New York City retailers, Matthew Flamm, Crain's January 23, 2017; Retailers Feeling Amazon Effect More Than Ever - Bloomberg <https://www.bloomberg.com/news/videos/.../fc9a5247-0166-48bd-8188-e5d3bdd230>; What in the World Is Causing the Retail Meltdown of 2017? Mark Blinch, The Atlantic, April 10, 2017.

2. How The 'Amazon Effect' Will Change Your Life And Investments www.forbes.com, January 16, 2017.

³ Retailers' Call Centers Bring Life to Dead Mall Space | Fox Business www.foxbusiness.com/features, Apr 25, 2017; Deserted Malls Find New Use As Retail Call Centers – Consumerist <https://consumerist.com/2017/04/25/deserted-malls-find-new-use-as-retail-call-centers/> April 25, 2017.

mall operators have upgraded their properties to create “experiential retail” spaces with attractive entertainment options such as restaurants, meeting spaces, theatres and skating rinks.⁵ Some landlords are now more willing to have short term tenants such as pop-up stores than they might have been in the past.⁶

Ironically, Amazon is considering the site of the former Randall Park Mall in Ohio (briefly the largest mall in the world when it opened in 1976) to use as a fulfillment center. On a cheerful note, Amazon intends to hire as many as 100,000 full-time and 30,000 part-time employees in the U.S. by mid-2018.⁷

Will ecommerce and changing consumer patterns result in a permanent negative impact on the retail market? Can failing retail centers be rehabilitated or are there too many brick and mortar stores chasing too few live retail customers? Whatever the answers to these questions may be, economic downturns in the past have taught us that a tenant should consider a lease exit strategy when entering into a lease. Although most leases contain assignment and sublet provisions, if they are not carefully crafted they may not result in a satisfactory lease exit strategy. Provisions such as terminations rights, gross sale thresholds and co-tenancy requirements should be considered and negotiated before the lease is executed.

⁴ Mall Landlords Lure Medical Providers As Retailers Bolt, Wall Street Journal, Esther Fung, March 28, 2017.

⁵ How malls are reinventing themselves for the e-commerce era, <https://www.washingtonpost.com>; Dec 19, 2014; Simon Property Group Fights to Reinvent the Shopping Mall - Fortune, fortune.com, Dec 2, 2016; The future of the shopping mall | McKinsey & Company www.mckinsey.com/business-functions/marketing.../ Roberto Fantoni, Fernanda Hoefel and Marina Mazzarol, The future-of-the-shopping-mall, November 2014; How malls are reinventing themselves; <https://www.amusementrc.com>.

⁶ Mall Owners Warm Up to 'Pop-Up Stores, Wall Street Journal, Esther Fung, August 16, 2016.
Journal

⁷ Will dead malls be the next logistics hubs?, The Real Deal, August 8th, 2017

Keep in mind that time-honored leverage factors (business track record, size of premises, balance sheet/desirability of tenant, desirability of premises, etc.) will always control all negotiations.

Termination Rights

Unless tenant is a government agency, landlord is unlikely to agree to a blanket termination right. After all, any bank evaluating making a loan to that landlord will assume the lease will be terminated and give it minimal value in assessing the property's income stream. However, a lease with a termination right narrowly tied to a particular event (such as the death of a key operator or the merger or acquisition of the business in a larger corporate transaction) will receive a higher valuation. This calculus is highly fact specific and should be carefully considered.

Tenant might also request a termination right if landlord becomes insolvent. Although a subordination, non-disturbance and attornment agreement (“SNDA”) may give tenant some comfort where landlord is foreclosed upon, the SNDA will probably not require the bank to fulfill certain landlord obligations including those relating to unpaid work allowances. Tenant may want the SNDA to provide it with a rent credit equal to any such unpaid allowance. A powerful tenant could require escrowed funds to cover same.

Gross Sales Thresholds

Under certain circumstances, a landlord might agree to a termination right where a specified sales point is not achieved by a certain date. This makes sense both for a tenant concerned about the viability of a location and for a landlord who seeks to share in tenant's sales through percentage rent. Landlord will require prior notice of a termination election and recoupment of costs such as

improvement allowances and brokerage. No termination right would be available to a tenant who failed to operate at full capacity, otherwise an intentional slowing down or “going dark” could trigger a termination right.

Co-tenancy Requirements

A co-tenancy provision requires landlord to have certain occupants open and operating at its mall as of tenant’s lease commencement date and throughout the term. For example, a high-end fashion retailer may require that its lease not commence until specified other high-end retailers are open and operating. Today it is customary for a space lease in a new mall to require that the anchor stores and a negotiated percentage of retail stores be open and operating as of the commencement date. Sometimes a lease will commence but only percentage rent will be payable with base rent not due until the co-tenancy threshold has been met. The agreed rationale is that sufficient foot traffic (e.g. customers) at a mall is necessary to justify rent payments for a tenant.

Similarly, a co-tenancy requirement can apply throughout the life of a lease. A mall tenant pays rent based upon an agreed set of circumstances. If a key anchor tenant goes dark, there will be less foot traffic and the location will become less valuable. To protect itself, landlord will often negotiate for time and flexibility in order to get a replacement anchor tenant (or percentage of other tenants, as the case may be) before a termination right is triggered. Since department stores are on the decline, a landlord may negotiate that an anchor department store can be replaced by two or more smaller stores or other draws to the mall such as a destination restaurant. The retail tenant when negotiating the lease provision relating to a hypothetical anchor replacement must determine if the new tenant will generate the right kind of foot traffic for its business. Landlord, too, needs to be careful in the drafting or it may be left with no viable replacement. For example, if the lease

provides that a departing Barnes & Noble must be replaced with a Borders Books or an equivalent national bookseller, such a retailer will be difficult to find.

Likewise, a replacement tenant provision that is too narrowly drawn can backfire on landlord: where a provision requires a national food retailer, a strong regional food store such as B.J.'s Warehouse will not qualify as a replacement. To ease landlord's anchor replacement process, a reduced rent period can be tenant's remedy before its actual termination right is triggered. Some landlords will require tenant to demonstrate economic harm before a co-tenancy termination right can be exercised.

Subletting and Assignment

Assignment and subletting rights can be reliable exit mechanisms, but the devil is in the details. In an economic downturn, it is likely that tenant is competing to sublet with several other tenants and may not be able to obtain a suitable sublessee to pay all the rent. Generally, landlord will not release tenant from its lease obligations. Besides the actual assignment and subletting provision, the provisions relating to use, trade names signage and alterations can also create hurdles to subletting or assigning.

In any event, tenant will want as broad assignment and subletting rights as possible. If the lease imposes no restriction at all, then Tenant has an unlimited right to assign or sublet because the law generally does not favor restrictions on the alienability of real property. However, in New York, if the lease just requires landlord's consent, the courts have ruled that landlord may refuse consent arbitrarily and for any reason or no reason at all and it may even extract a payment

as a condition for the consent. There is no inferred landlord obligation to act reasonably unless the lease specifically so requires.⁸

Tenant will want landlord to agree not to unreasonably withhold, delay or condition consent to an assignment or sublet. As expected, there are hundreds of cases interpreting what constitutes reasonable behavior in different circumstances, so a trier of fact is the ultimate arbiter of what is reasonable. In American Book Co. v. Yeshiva University Development Foundation, 297 N.Y.S. 2d 156,160 (Sup. Ct. 1969), the court set out four factors that are reasonable for a landlord to consider in determining whether to agree to an assignment or sublet: 1) financial qualification of the proposed subtenant; 2) the identity or business character of the subtenant – i.e. its suitability for the particular premises; 3) the proposed use; and 4) the nature of the occupancy. We shall consider each factor below.

Financial qualification is the most objective criteria. A landlord is entitled to satisfy itself that the proposed subtenant has the economic ability to fulfill its obligations to pay rent and to perform the lease obligations. This can require an evaluation of net worth and liquidity. To review subtenant's identity/business character, considering whether the proposed subtenant has relevant business experience or is a current tenant of landlord has been found to be reasonable. For use: is the proposed use prohibited by other tenant's exclusive rights? Will such use over burden the premises or parking?

What factors might a court deem unreasonable? Unreasonable grounds for denying consent include considerations of mere taste and personal idiosyncrasies of the landlord. In Am. Book Co. v. Yeshiva Univ. Dev. Found., Inc., 297 N.Y.S.2d 156 (Sup Ct. 1969), the Court found that the landlord could not withhold

⁸ See Mann Theatres Corp. v. Mid-Island Shopping Plaza Co., 464 N.Y.S.2d 793 (App. Div.1983) aff'd, 468 N.E.2d 51(N.Y. 1984)

consent based on a philosophical and ideological objection to the proposed tenant's business.

To avoid the uncertainty as to what is a reasonable withholding of consent, some leases specify permissible factors which landlord may consider in deciding whether or not to refuse consent to an assignment or sublet. These lists can be long and detailed. For example, landlord may require a particular net worth threshold, restrict assignments to government offices such as the Department of Motor Vehicles, or reject any proposed subtenant that had previously negotiated for space directly with landlord in the last six months.

Additionally, Landlord usually requires tenant to reimburse landlord's expenses in connection with an assignment or sublet, and pay any sublease profit to landlord. In any such provision, tenant should be sure that profit is defined as *net* profit so that brokerage, alterations, marketing, legal, free rent and other expenses incurred in connection with the sublet are offset against the income. Further, tenant's profit participation payments to the landlord should be due only to the extent tenant actually receives them. If there are installment payments, and the subtenant or assignee defaults, tenant should be able to stop paying and perhaps be entitled to claw back any payments already made.

Process and timing of a consent request can be critical. Often the lease will require a fully executed assignment or sublease to be submitted to landlord for review. Try to have the lease provide that a signed term sheet will suffice to initiate the consent review period instead of waiting for a final fully executed sublease that ultimately may not be approved. Similarly, notwithstanding landlord push-back, try to have the lease provide a time certain by which landlord must respond to an assignment or sublet consent request. Failure to so timely respond will be deemed consent granted. Remember, delay can foil a deal.

Even if there is a broad assignment or subletting right, a retail tenant can be thwarted by a narrowly drawn use clause which can block an otherwise satisfactory exit transaction. It is typical for a retail lease to specify a limited use for the property. However, if a tenant can only sublet to a store with the same use and all stores with that use are under economic pressure, tenant could be effectively left with no exit. Tenant should try to negotiate a broader use provision in the event of an assignment or sublet even though landlord may resist claiming it knows best what retailers should be in its mall.

A lease provision requiring tenant to operate its business under a specified trade name only can also hinder assignment or subletting. Such a requirement may block a satisfactory exit plan unless the tenant sells its business to an entity who will continue to operate it under the same trade name.

Keep in mind that landlords typically reserve certain rights relating to exterior and interior signage and alterations. Similarly, some leases provide that renewal rights and expansion option do not accrue to a sublessee or assignee. Such restrictions might make tenant's space less palatable to a replacement tenant.

Other Solutions

If tenant is not strapped for cash but is unhappy with a particular location, it could offer to buy out its lease. The buyout price would be determined by negotiation and would turn on several factors including landlord's ability to find another tenant, the remaining term of the lease, and landlord's unamortized construction and brokerage costs.

Sometimes a struggling tenant will ask for a temporary rent reduction or decrease in percentage rent. Landlord might consider such a request given the totality of the circumstances, but might couple it with a termination option if landlord finds another tenant. Landlord would likely not allow tenant to sublet at

the reduced rent without the profit going to landlord notwithstanding such any rent concession.

Tenant should review the lease and current circumstances for a landlord default that could allow tenant to terminate the lease. For example, if landlord is not providing all services required under the lease this might give rise to a tenant termination right. Note that it is just as likely that an attempt to terminate the lease for a landlord default will end up in litigation absent a clear right or egregious lease violation.

The Lender's Role

A behind the scenes party in a lease exit negotiation can be landlord's lender. Applicable loan documents may require that certain debt service covenants be met. Similarly, there may be certain reserve requirements in connection with brokerage commissions and tenant improvements which can hinder landlord's flexibility. Likewise, a lender may have approval rights over any lease modification. Tenant should evaluate lender's role before embarking on any lease exit strategies.

Conclusion

Although the Amazon effect has changed the course of retail leasing, other events over the years have disrupted retail markets: economic downturns, fads and even inventory shortages. Both retail tenants and landlords need to be optimistic and nimble to succeed in their businesses. In the past, many lease terminations occurred because shoppers did not want to buy what the retail tenant was selling. Today, many lease terminations occur because shoppers don't need to leave their homes to buy almost anything. Given the magnitude of both a landlord's and a

tenant's investment in a retail store at a time of such uncertainty, both sides should be creative and accommodating when faced with failing results. Pre-negotiated, creative and even-handed lease termination provisions can save both sides a lot of pain and expense.

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