Hot Topics for Commercial Property Owners and Managers: 2014 Update

Russell A. Arouh, David J. Marmins, C. Knox Withers and Brian R. Smith

Arnall Golden Gregory, LLP's Retail Industry Team presented a breakfast briefing panel discussion on Nov. 5, 2014, covering a variety of hot issues facing retail and office owners and managers. The panel, comprised of AGG real estate transactional and litigation attorneys, shared its analysis on a variety of pertinent topics, including best practices and lessons learned from recent deals and cases, important judicial decisions, and insights from last month's ICSC Law Conference. The purpose of this AGG Legal Insight is to summarize some of what we covered at the breakfast.

Unconventional Uses of Retail Space

More and more, we are seeing tenants operate businesses that, years ago, were nowhere to be found in retail shopping centers. But today examples of "unconventional uses" abound, including pop-up stores, medical service providers, electronic cigarette (or "vape") stores, cigar lounges, and even casket sales. With these burgeoning uses come unique issues that owners and property managers would be wise to anticipate. Do these tenants drive the *right* traffic to the center? Do these tenants complement the existing merchant mix? What problems do unconventional uses present? The panel specifically addressed the following industry trends:

- ***Pop-Ups.*** Pop-up shops are selling a lot more than Halloween costumes and Christmas decorations these days. They have become an increasingly popular way for landlords to fill empty space on a short-term basis while seeking a more permanent tenant. A pop-up shop can take an otherwise dark location and turn it into a vibrant space that drives traffic and spurs future leasing activity.

  While pop-up shops certainly have their merits, they can be perilous to owners and managers if the contract details are not given the proper attention. There is a natural temptation to rush through deal-making given that the pop-up tenant will likely be short term. But a lot can happen in just a short time, and owners and managers need to ensure that pop-up tenants play by the rules. For example, before opening, a pop-up shop should be aware of, and subject to, the exclusive and restricted uses applicable to a shopping center, as well as the rules and regulations that govern day-to-day operations. Pop-up tenants should provide insurance certificates naming the landlord as an additional insured. Typically, a landlord should sign a pop-up tenant to a license, not a lease.

  In sum, while pop-up shops often have a fun, quirky, short-term use, landlords should be certain to treat them much as they would any other occupant of a shopping center when it comes to property management and administrative functions.

- ***Medical Clinics.*** Leases with existing tenants and recorded shopping center documents might preclude a landlord from allowing certain medical uses, such as emergency clinics and dialysis clinics. For example, a tenant's lease might prevent the landlord from leasing space to a tenant that handles biohazardous materials or generates medical waste. Medical tenants are also often subject to HIPAA requirements. Leases should require that tenants take steps to maintain the privacy of patient records, and property managers should consider periodic audits of compliance with the lease's security provisions. A landlord must

also ensure that tenants dispose of hazardous materials, bodily fluids, needles, and medical waste in a lawful and responsible manner. Maintenance is especially critical because failure to maintain the premises and to address pest problems in nearby spaces could result in a medical clinic's loss of licensure, which, in turn, could place a landlord in default of the tenant's lease.

- ***Traditional Office Tenants.*** Leases and recorded shopping center documents might similarly require that the shopping center remains "retail" in character. That said, a number of office or service retail uses have been introduced to centers in recent years, including financial services centers, insurance companies, and tax preparation services. While these uses are more common, a true office use might be frowned upon due to the parking requirements that such a use would demand, not to mention that such tenants frequently require more "hand holding" than traditional retail users.

Use Clauses and Exclusives

Landlords are pushing harder than ever for restrictive use clauses and tenants are pushing back. The landlords won a legal victory in a recent major case debating the breadth of a common grocery store exclusive. The tension created by use and exclusive leasing provisions was a frequent subject at the ICSC Law Conference and during the panel discussion.

- ***Types of Use Clauses.*** Typically landlords want to use well-defined use clauses that explicitly state the exact use for the premises. This allows the landlord to control the merchant mix of the center and to ensure that tenants do not cannibalize each other. Tenants, on the other hand, want a broad use, including "any lawful use" or "any lawful retail use" so as to protect their ability to evolve over time and their ultimate exit strategy should their business not keep up with projections.

- ***Ensuring Compliance.*** It may not be sufficient to simply insert a use clause into a lease and trust that the tenant will abide by it. Often, businesses change and expand, and that can implicate the use clause. Consider the real-life example of one landlord who purchased a shopping center that included a restaurant tenant. A fire destroyed the premises, and the lease required the landlord to rebuild it. Unfortunately, the premises were permitted only as a catering operation, and the tenant never applied for a restaurant permit when his business expanded. The tenant eventually sued the landlord for failure to repair the premises, even though the delays were primarily the result of the tenant's own failure to obtain the proper operating permit.

  Property managers should audit tenants to ensure they are operating in compliance with use clauses. Landlords who acquire shopping centers should confirm that the tenants they inherit are operating consistent with their certificates of occupancy.

- ***What Are "Groceries," and What Does "Sales Area" Mean?*** In the 2014 decision in *Winn Dixie v. Dolgencorp*, the Eleventh Circuit Court of Appeals gave life to Winn Dixie's claims against 97 discount retail stores by broadly interpreting the exclusive right of Winn Dixie to sell "groceries" in specified "sales areas." The court, siding against Dollar General, Dollar Tree and Big Lots, ruled that the term "groceries" in Winn Dixie's exclusive contract did not mean just "food," but meant food plus a long list of consumables, such as paper products, soap and other non-food items typically sold at a grocery store. The court also ruled that "sales area," which the trial court had decided meant only the shelving space, also included the aisles. The court also decided that the tenants could sue each other, and not the landlord, for violating the exclusive.

- ***Exclusive Uses and Using the Right Measuring Stick.*** Crafting an exclusive use can be a perilous exercise, especially in the food and beverage arena. With restaurants offering ever-expanding menus and a fusion of cuisines, nailing down exclusive-use language that not only protects the tenant but affords the landlord future leasing flexibility, can be tricky. Usually, Letters of Intent use a "percentage of gross sales" standard to measure a tenant's exclusive-use protection. A common example of an exclusive use might be "no future tenant of the shopping center shall derive more than ten percent (10%) of its gross sales from the sale of hamburgers." Enforcing such provisions can be difficult and unduly restrictive of future leasing efforts.

A property manager might need to jump through endless hoops if the beneficiary of such an exclusive-use provision alleges a violation. By the time the property manager requests the potential offender's statements of gross sales, reconciles them, and responds to the allegation, the landlord may already be in default. A better solution would be to use a "number of menu items standard" or a "square footage of sales area standard." These are finite and easily determinable standards to enforce. If the exclusive use read that "no other tenant would serve hamburgers as more than ten percent (10%) of its menu items," everyone benefits from the additional level of clarity.

Moreover, the landlord's leasing agent will be free to make deals with future tenants who might want to sell some of the protected product as an incidental use. Using the hamburger example, a future restaurant tenant offering a hamburger on its menu might be scared off by an existing exclusive use which states that no other occupant of the center can derive more than ten percent (10%) of its sales from the sale of hamburgers. How can an operator control how much or how many of an item its customers order? "I'm sorry sir, per our lease, we can't sell any more hamburgers today. Your order would put us at 11%. Feel free to orders something else though!" This may sound odd (and it should), which is why the forward-thinking owner and leasing agent are frequently abandoning the "percentage of gross sales standard" in favor of standards that are more within an operator's control and more enforceable.

CAM Audits and Disputes: Is "Fixed CAM" the Answer?

CAM costs are often complex and result in unexplained expenses, difficult reconciliations and ambiguity. The panel discussed whether the benefits of "fixed CAM" outweigh the downside.

- ***Fixing CAM Fixes a Lot of Problems.*** Many landlords are moving away from CAM calculations toward fixed-CAM increases. For example, a lease might simply read that CAM will be $5 per square foot for the first year of a lease term, with fixed increases of 5 percent annually. While a bit of an art form to set the correct percentage of fixed increase in advance, there's no doubt that fixed CAM eliminates a lot of property management headaches. Fixed CAM eliminates negotiating laundry lists of CAM carve-outs and auditors camping out in the landlord's property management offices! Landlords need no longer calculate which items can be passed through to which tenants, and the correct percentages of each item to be allocated among them. While still a movement in progress, larger landlords are finding they are able to spread the fixed CAM risk across their portfolios, thus freeing up their managers and deal-makers to spend their time on more fruitful (and fun) property management and leasing efforts.

  While fixed CAM has certain advantages, it also has drawbacks. If a landlord does not have a long operating history with the property, fixed CAM may come in low. Or, there may be a number of uncontrollable property expenses in the form of security, utilities and snow and ice removal. While this may well be a profit center for the larger developer, we caution smaller entrepreneurs to tread lightly before agreeing to a fixed CAM budget.

Landlord's Right to Self-Help: "Can I Change the Locks?"

Our landlord and property management clients frequently ask whether they can exercise "self –help" by retaking possession following a tenant's default by changing the locks on the door. They perceive the prospect of a dispossessory proceeding as too lengthy and costly. Unfortunately, even though some states may authorize landlord self-help (and some states *prohibit* it), it's almost never a good idea. There is simply too much risk and not enough reward. Yes, a landlord might recover the premises more quickly through self-help than through legal eviction proceedings. But, in doing so, the landlord exposes itself to liability for conversion of property, wrongful eviction, and other damages. Unless a tenant has clearly and unequivocally abandoned the space *and* removed all of its property, avoid landlord self-help at all costs. Following the dispossessory process is the landlord's best insurance policy against frivolous tenant claims.

Authors and Contributors

Russell A. Arouh
Partner, Atlanta Office
404.873.7032
russell.arouh@agg.com

David J. Marmins
Partner, Atlanta Office
404.873.8126
david.marmins@agg.com

C. Knox Withers
Partner, Atlanta Office
404.873.8129
knox.withers@agg.com

Brian R. Smith
Associate, Atlanta Office
404.873.7002
brian.smith@agg.com

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Atlanta Office
171 17th Street NW
Suite 2100
Atlanta, GA 30363

Washington, DC Office
1775 Pennsylvania Ave., NW,
Suite 1000
Washington, DC 20006

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