

## Tracking the Evolution of the Retail Lease

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To borrow from Mark Twain's famous quote, the reports of the death of retail (and the retail lease) have been greatly exaggerated. In fact, although reports of the demise of the brick-and-mortar retail establishment have abated, it was not long ago that many were claiming that traditional U.S. retail was dead—never to return.

But with the benefit of time, it would seem that a more accurate prognosis is that retail is now in the midst of a dramatic evolution. Rather than dying, the retail landscape is changing, and being changed, by numerous forces. And so, landlords of such properties, as they plan to meet these changes by reconfiguring and repositioning their properties, should also consider changing their approach concerning the retail lease.

The retail lease is the retail landlords' primary document governing their properties. In addition, it spans a multi-year term and therefore—unlike a purchase and sale agreement—is an agreement that creates an ongoing relationship between two parties. Therefore, especially in certain cases (such as a 50-year retail ground lease, for example), it must establish the parameters of a long-term relationship of the parties, while allowing for inevitable and also unforeseeable changes that occur over time.

In order to evaluate the evolving retail lease in this context, where rapidly changing forces are necessitating a reexamination of the relationship document called the "retail lease," let us start by noting certain provisions that have become scarce among these agreements. For example, the ongoing co-tenancy clause, once a ubiquitous tenant tool, especially for larger retail tenants (often big-box shopping center tenants), is now rarely seen in retail leases. This should not be surprising. After all, how could a retail landlord agree to such a concept—that a tenant be allowed a significant rent reduction or a lease termination right if another co-tenant in the center decides to go dark—when retail, as mentioned, is undergoing such profound changes? Landlords simply cannot risk such a bet, that its tenant mix will remain static in a retail environment that is anything but static, no matter what the particular tenant's leverage is.

Another formerly common retail lease concept is percentage rent. Simply, how could a retail landlord agree to percentage rent when, for many retail tenants in the digital era, selling products from its stores is becoming less of the focus? And that is a point worth emphasizing. Perhaps the most significant development that the retail lease needs to navigate, from both the landlord and tenant perspective, is that it is becoming less of an agreement concerning the sale of products. In fact, the whole meaning of "retail" is changing, which of course means that the meaning of the "retail lease" is necessarily changing too.

Although retail tenants have certainly not abandoned the notion of selling goods in their brick-and-mortar stores, for many of them, such premises are becoming an *experiential* place.

Although many retailers can sell their products in cyberspace, a brick-and-mortar store is still needed, where the customer can see, touch and handle the product, experience the retailer's offerings and brand, and perhaps be amazed and entertained through a sensory experience. This is where the physical retail premises are heading, and the way in which "stores" will remain vibrant and necessary.

As this new purpose of the retail store emerges, is there any wonder why co-tenancy requirements and percentage rent provisions are becoming obsolete?

Conversely, as some traditional retail locations are morphing into non-retail, but experiential, spaces, mirror-opposite changes are occurring as well, completing the evolutionary circle. Specifically, office and even industrial properties are now wading into the retail waters, adding to this dynamic.

To illustrate, I recently negotiated three leases, two of which were, primarily, for office space, and the other was for a large industrial/warehouse facility. However, all three tenants required a retail use to be allowed in their premises. The industrial tenant, an alcohol-beverage distributor, required a significant portion of its 200,000 plus square foot premises to be used as a tasting room. Perhaps that is not a pure retail use like a tavern—the tasting room was to be used for salespeople—but this tenant's need necessitated, from a lease negotiation perspective, traditional retail provisions concerning approvals, a liquor-license contingency, special parking needs, operating hours, and even signage. Certain liability issues and insurance requirements, that were not previously an issue for this industrial landlord, now were essential points to be raised. When this lease was completed and signed, it was hard to tell where the industrial lease provisions ended and the retail ones began.

The other two examples were office leases, but like the industrial-lease example, the tenants had to use a portion of their space as a showroom for merchandise. This "experiential" need was critical for both tenants (much like the tasting room), and it was a condition to each deal. For one of the leases, zoning issues had to be addressed, and for the other, because it was a sublease, the retail restrictions and prohibited uses in the prime lease had to be completely revamped.

Thus, in a world where the retail lease is becoming less about selling goods to the public, and office and industrial leases must incorporate retail-like uses, how does the traditional landlord's lease survive? The answer is that it doesn't. It must evolve with these changes. Outdated retail concepts, which either fix a tenant mix or disproportionately rely on the sale of goods from a premises, need to be revised, if not discarded. While certain other retail ideas, not previously worth mentioning for other types of leases, now need to be considered and negotiated.

The above are mainly examples of lease changes that we have seen. But what about the changes that are only just emerging within the retail world, and what about unforeseeable changes? How does the retail lease adapt to that?

Consider Amazon, not for the changes it forced onto the retail universe by way of its internet-based platform, but for its recent foray into the brick-and-mortar world with its acquisition of

Whole Foods. In this case too, traditional retail is being transformed, and so will the retail lease. For example, as has been reported, Whole Foods is now looking to offer multiple product lines, beyond that which is typically offered in grocery stores. If and when this becomes a reality, this will undoubtedly have an impact on another retail-lease favorite—the tenant’s exclusive use provision. Specifically, how could a landlord agree to an evolving exclusive for the benefit a supermarket tenant in an environment where the neighborhood grocer sells books, bicycles, maybe even financial services and products? The new retail lease will certainly have to address that.

Sticking with the “supermarket of the future” example, much has also been reported about drones acting as a new delivery system. Soon, it is possible that rather than the traditional model of customers coming to the grocery store, the store’s goods will be transported directly to the customer. This upheaval will also dramatically change retail and, therefore, the retail lease. We can only begin to speculate how the lease of the future will have to address these fleets of drones, but surely it will have a big impact on the way parking rights are allocated in the lease (not to mention how parking lots are designed in the field), as well as other issues mentioned above, such as hours of operation and, never to be minimized, liability issues.

Like it or not, retail in the U.S. is undergoing great changes, with no sign of going back. Some changes we have already seen, like the evolution of the experiential retail space, while others, like drone-based delivery systems, are only now emerging from what could have been characterized as a sci-fi novel not too long ago. Accordingly, retail leases are evolving too (along with office and industrial leases), as they should. Traditional lease concepts, no longer applicable in many cases, are being discarded, while new provisions, sometimes from other types of leases, are now encroaching to and from the retail lease. It is a fluid and exciting time for retail, which is surely not dead. Landlords that appreciate these changes, and seek to update their retail leases, will surely benefit in the fast-approaching future.

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