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## Law & Accounting

### Retail acquisitions: Avoid lemons

There are many factors that affect the value of a shopping center. These include location (location, location), tenant mix and financial strength, competing shopping centers and a physical condition of the structures, just to name a few. However, one of the primary methods of valuing a shopping center for acquisition is based upon the capitalization of the income stream generated by the leases. It is not a great leap to say that a shopping center's income stream is as good as the leases upon which it is based.

Although there are innumerable issues that must be considered when evaluating shopping center leases in the context of an acquisition (including common area expense pass-through and percentage rent provisions), this article examines four common types of lease provisions that can impact value. Reviewing exclusive use, termination and rent reduction, go-dark and redevelopment-limiting provisions of a shopping center's leases will help ferret out the existence of lemon leases during the due diligence process.

■ **Exclusive-use provisions.** In order to attract a tenant, landlords often grant an exclusive right to sell a particular service or good within the shopping center. It is not uncommon for a landlord to grant exclusive-use rights to tenants that conflict with uses that are permitted under then-existing leases or that directly conflict with another exclusive-use right. For example, if one tenant is permitted to use its premises for "any lawful purpose," exclusive rights granted to a second tenant to sell "women's shoes" could be violated by the first tenant (even though its current use does not include the sale of women's shoes).

If an actual or potential conflict exists among exclusive-use provisions of the shopping center's leases, the buyer could later become



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embroiled in expensive litigation with one or more of the tenants. This could lead to the buyer suffering the termination of a lease, lost rental income or liability for damages. In response to use concerns raised by a buyer, a seller may offer comfort by pointing out that a dispute has not arisen after years of occupancy under the offending leases. This may be cold comfort for a buyer since exclusive-use conflicts often arise when a tenant's business changes (by design or necessity) or the lease is assigned to a new occupant with an offending use.

It is often difficult to quantify the risks associated with conflicting use rights. To become comfortable with potential conflicts, a buyer may seek a reduction in the purchase price to compensate for uncertain risks or may ask the seller to seek amendment of the conflicting leases before closing.

■ **Termination rights and rent reduction.** A tenant going into a new location often will request a right to terminate the lease if its business is not succeeding. Such rights may be based upon the tenant's failure to reach certain sales targets within a specified time period, a vacancy rate in the shopping center exceeding a specified percentage, or an absolute right that must be exercised on or before a set date. Many times such clauses will require the tenant to give a generous notice of its election to terminate (allowing the landlord time to relet

the space) and to pay a termination fee as compensation for lost rent, unamortized tenant improvement and unamortized brokerage commissions.

Some shopping center leases also may allow a tenant to decrease its rent during certain specified periods, such as when another occupant of the shopping center is violating an exclusive-use provision or when the vacancy rate in the shopping center exceeds a specified percentage. Rents may be reduced to a specified amount or limited to percentage rent amounts otherwise payable under the lease.

If leases contain termination rights or rent reduction rights, a purchaser should carefully evaluate the potential economic impact of these provisions upon the value of the shopping center.

■ **Go-dark provisions.** If a business is losing money, it may be less costly to shut down the business and simply pay rent (rather than paying rent, employees' salaries, utilities and the cost of carrying inventory). Some leases contain provisions allowing a tenant to shut down its business ("go dark") and to continue paying rent without constituting a breach. If a tenant exercises its right to go dark, the vacancy could have an adverse impact on the shopping center that a buyer should factor into its valuation.

■ **Restrictions on buyer's redevelopment plans.** If a buyer intends to create value by redeveloping a shopping center, certain lease provisions that might not otherwise be of material concern become very significant. Under this acquisition scenario, it is important to analyze the shopping center leases to determine if they contain any impediments to redevelopment.

All leases in the shopping center should contain a broad right allowing a buyer to make modifications, additions and deletions to the com-

mon areas in connection with its planned redevelopment. If such provisions are absent, it might alter or doom the buyer's intended plans. Lease provisions allowing a buyer to relocate a tenant are always a plus for redeveloping a shopping center, but the costs associated with such relocation provisions must be quantified. Lastly, it is common for tenants to include in their leases a restriction upon the landlord's ability to make modifications to the shopping center or common areas that would materially affect the visibility, access routes to or parking for the premises. Depending upon the location of premises subject to such restrictions, a buyer's plan for value-added redevelopment could be brought to an end.

Unfavorable lease provisions that may adversely impact redevelopment are not necessarily the death knell for an acquisition. A buyer should consider asking a seller to cooperate with negotiating modifications to problematic leases that will become effective upon closing. If the seller is unwilling to play ball on preclosing lease modifications, the buyer should evaluate the likelihood, and estimate the cost, of obtaining post-closing modifications to leases that will allow buyer to proceed with its redevelopment plan.

Evaluating exclusive-use, termination and rent reduction, go-dark, and redevelopment-limiting lease provisions during the acquisition due diligence process enables a buyer to determine the true and potential value of the income stream generated by a shopping center's leases. And, if fate does hand the buyer some lemon leases, instead of making lemonade, a buyer will be in position to demand a price reduction, request amendments to problematic leases before closing, or make a decision to walk away from the deal. ▲