Financing Issues to Consider When Negotiating Retail Leases in Strip Centers

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The author explores some of the unique leasing issues to consider with respect to the financing of mini malls.

The strip center, sometimes referred to as an in-line center or mini mall, has become a well-known fixture dotting the suburban landscape across America.

Generally speaking, a strip center is a single free-standing building or at times two or more smaller buildings, totaling at the most 20,000 to 30,000 square feet of retail space and containing two or more tenants. Typically, these tenants are national chains, super regional chains or on occasion local mom and pop stores such as pick-up and drop-off dry cleaning stores, ethnic food restaurants and local delicatessens. Often these strip centers are located on former gasoline station sites, along high-density surface streets and closely accessible to major intra and interstate highways.

Other models of in-line centers are located on pad sites along the ring roads in regional malls and big box centers anchored by such stores as Wal-Mart, Lowe's, and Home Depot. Unlike big box shopping centers, regional malls, lifestyle centers or other large retail centers, strip centers tend to have no anchor tenants nor do they contain a single dominant tenant located in the center.

This article explores some of the unique leasing issues to consider with respect to the financing of mini malls. It is important to keep many of these concepts in mind when negotiating a retail lease at a small center prior to entering into financing with a lender.

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Damage Caused by Fire or Other Casualty

The owner of a relatively small shopping center and a correspondingly modest note tends to have a bit less leverage with the lender than an owner of a large regional mall. Of course, owners of strip centers that are high volume borrowers (meaning that they do many loans in the mid-market, $2,000,000 to $10,000,000 category) or that may be the developers of large regional malls, office buildings and apartments, in addition to their strip mall development portfolio, may find that they have additional bargaining power with the lender; however, as a general rule, for many strip mall developers, such bargaining power tends to be limited.

A mini-mall borrower's lack of leverage becomes most evident in the fire and casualty provisions contained in the loan documents. In larger centers with more substantial loan amounts, lenders tend to be more willing to negotiate the casualty and fire provisions more heavily, while in smaller centers, lenders tend to have a more ''take it or leave it'' approach in determining how the insurance money should be applied in the event of such a casualty or fire. In order to protect its interest and not run afoul with either the loan documents or the lease document, the borrower must under-

stand and balance the requirements of the lender with the requirements of the prospective tenants.

Most sophisticated tenants, and certainly national tenants, will require that in the event of a casualty, the provisions of the lease shall control. Unfortunately, most lenders will not agree to allow the tail (in this case the tenant) to wag the dog (in this case the bank). Rather, most lenders will require that it determine, at its sole discretion, whether the insurance proceeds will be used to pay off the loan or restore the center to its pre-casualty condition. A lender may take into account the numbers of years left in the loan, the profitability of the center and even its relationship with the borrower in assessing the direction it wishes to proceed.

Borrowers may employ a number of suggested revisions to allow the maximum flexibility to which lenders generally will agree. The borrower should request that the lender permit it to use insurance proceeds in the event less than 50 percent of the center is damaged by fire or casualty. Lenders typically look for a number closer to 20 percent to 25 percent but will typically agree to a number as high as 35 percent. In addition, some lenders will agree to more flexibility with insurance proceeds if the casualty occurs earlier in the term of the loan. A borrower should raise with the lender the possibility of maintaining full flexibility to restore the shopping center for at least the early years of the loan repayment period.

As noted above, most tenants, especially those with substantial tenant improvements paid for by the tenant directly or as part of a landlord's tenant improvement allowance, may not be keen on permitting the lender to control rebuilding of the center. While the tenant will have insurance on its personal property and in theory will have the ability to use the insurance to rebuild, without a premises to rebuild, such insurance proceeds do a tenant little good.

Ideally, the fire and casualty provision should provide that the landlord is not required to rebuild the premises. As noted above, tenants, particularly sophisticated tenants, will not agree to such a provision. In the event a landlord is required to rebuild the building, it should be subject to the borrower's receipt of the lender's approval, the receipt of insurance proceeds sufficient to rebuild the building and the receipt of permits for the necessary approvals to reconstruct the building. It is particularly important to tie the rebuilding period to the satisfaction of the above conditions rather than the actual casualty. Otherwise, the landlord may be in a position whereby the period to rebuild has passed and the tenant terminates the lease but the owner of the building is not yet in a position to rebuild. By conditioning rebuilding on the above, an owner is able to hedge against the potential denial of a claim from the lender, failure to receive permits and approvals, or failure to receive adequate insurance proceeds.

Subordination, Nondisturbance, and Attornment Agreement

Many tenants, however, take the position that conditioning the obligation to rebuild does not protect their interest in the premises in the event of a fire, casualty, or even a condemnation. Tenants view this as an unacceptable risk that may cause them to lose their substantial investment in the property in the event of a casualty by virtue of a lender not authorizing the release of funds. At times, this impasse can be addressed in a Subordination, Nondisturbance and Attornment Agreement (''SNDA''). Ideally, the lease will provide that the lease is in all cases subject and subordinate to the loan agreement. However, many sophisticated tenants will not accept this provision unless the lender agrees that the tenant's right to occupy the premises will not be disturbed in the event that the lender steps into the shoes of the landlord.

The SNDA essentially performs three functions. First, the SNDA states that the lease is subordinate to the loan. This is important because in many cases, especially in refinances or development deals, the lease is entered into prior to the loan. Unless there are provisions in the lease agreement that specifically state that the lease is subordinate to any loan that is put on by the landlord affecting the property, the lease will be deemed superior to such mortgage. Second, the SNDA provides that in the event the lender steps into the shoes of the landlord following a foreclosure, default or other such event, the tenant will attorn or recognize the lender as the landlord. Third, in exchange for such attornment, the lender agrees that the tenant's interest in the premises, even though subordinate, will not be disturbed by the lender (provided the tenant is not in default). This means that the tenant will be able to stay in the premises following a default and subsequent foreclosure by the lender.

In addition to the three main provisions of the SNDA, other issues that affect the financeability of the lease tend to be major sticking points in negotiating leases, lender's documents and ultimately in closing deals pertaining to the SNDA. Specifically, the issue of how proceeds from casualties, fire, and condemnation will be disbursed may be discussed more fully in the SNDA. In addition, the issue of a lender's responsibilities as to a landlord default can be addressed in the SNDA. The other main issue in executing the SNDA is the extent to which a lender must assume the obligations of a landlord with respect to a pre-existing default.

Many times, it is helpful to forward the form SNDA of a tenant to the proposed lender for review and comment prior to entering into the lease. This will help streamline the SNDA execution process at the time of closing on the loan. Too often the final issue with respect to closing a loan is not the loan documents or opinion letters or due diligence but rather the execution of the SNDA. By addressing this concern early on, many of these issues can be alleviated in advance.

In the event that the tenant or the lender are not in agreement on the SNDA prior to the execution of the lease, the lease should provide that any SNDA must be

mutually acceptable to the lender, the landlord and the tenant rather than simply on lender's and/or tenant's form. This is more likely to force a tenant to act reasonably.

Co-Tenancy

Co-tenancy issues exist in large and small shopping centers. Typically, a co-tenancy provision deals with the number of tenants that need to exist either or both for the opening or continued occupancy in the center in which the tenant is an occupant. Unfortunately in the strip center scenario, it is inadvisable to allow an opening or operating co-tenancy especially where there are only three or four tenants. Many times however, the co-tenancy tenants are most concerned not about those stores in the center but rather the big box tenants (e.g., Wal-Mart, Sam's Club, Lowe's, Home Depot) anchoring the larger retail development.

The landlord should be careful in negotiating a provision tying a co-tenancy to a store outside of a landlord's immediate control. Care should be taken to ensure that the big box tenant will in fact be open at the time the strip center is completed. This is particularly an issue when the big box store located in the larger development is being constructed at the same time as the owner's strip center.

Even more important is the issue of the big box store going dark or closing. With the rash of bankruptcies of such companies as Bradlees, Ames, K-Mart, and others, this is particularly disconcerting for a landlord as well as a lender. Despite these concerns, banks are typically amendable to lending money to centers where store opening and continued occupancy is tied to the operation of a box tenant provided certain safeguards are followed. Specifically, the landlord should consider the following issues:

1. The earliest termination date should be at least five to 10 years from the rent commencement date.

2. The termination right of the tenant must be a one-time right. For example, in the event a big box store closes, the tenant must make its choice to terminate in a finite period of time.

3. The tenant must show a drop in gross sales (e.g., 25 percent to 50 percent) over the previous year due to the termination of the big box tenant. Given that the tenant has entered into this lease based on the strength and draw of the big box tenant, if its business thrives regardless of the big box tenant being open, the tenant's termination right should expire.

Financials

In the event that a large portion of the strip center is taken by a single tenant (e.g., 10,000 square foot Dollar Store or large restaurant) whereby more than 50 percent of the shopping center is leased by a single tenant, the lender may insist that it be permitted to review the financials of the tenant. This is particularly true where a large tenant is a super regional tenant that may be unknown to a national bank. It should be negotiated in the lease agreement that the tenant is required to give financial statements in a form reasonably acceptable to the lender and certified by the tenant or tenant's accountant. Typically such a form may be unaudited, but it is worth requesting that the statements be audited or at least certified by an authorized officer of the tenant.

Insurance

A lender, in addition to confirming that the owner has adequate insurance, will require that a tenant obtain insurance to cover general commercial liability and the tenant's property. Lenders (and for that matter landlords) do not want to be in a position whereby a center is rebuilt by the landlord but the tenant does not have adequate proceeds to build out their premises.

The insurance carried by a tenant may be in the form of self-insurance, or depending on the size of the tenant, an actual insurance policy. Most lenders will request that the tenant insurance be written so that it adds the lender as an additional insured. For that reason, it should be kept in mind when negotiating these insurance provisions that the landlord and lender should be added as additional insureds to the tenant's policy. Typically, a lender will require that the tenant has insurance to cover liability in a commercially reasonable amount. In small retail centers, $1,000,000 per occurrence and $2,000,000 in the aggregate will generally be sufficient; however, each transaction is different.

In addition to liability insurance, the lender will require that the tenant have sufficient insurance to pay for replacement costs of tenant improvements. For large national tenants, the lender may be comfortable with an amount equal to 80 percent of the replacement costs, but generally speaking, 100 percent of the replacement cost should be required to be carried by each tenant. Of course with large national tenants, some of this insurance may be in the form of self-insurance; however, lenders will request that in the event self-insurance is an option, the amount be subject to the tenant retaining a certain minimum net worth (typically $10,000,000 to $100,000,000 depending on the tenant). Additionally, lenders will at times require tenants to carry insurance at statutory amounts for workers' compensation and business interruption insurance. As a rule of thumb, one year's worth of business interruption insurance is sufficient.

The landlord should ensure that each of the above insurance requirements is addressed in the lease.

Continuous Occupancy and Opening Conditions

Many an article, law journal, and jurisprudence may

be cited with respect to the state of law regarding continuous occupancy and the obligation of a tenant to open and for how long. What a court may ultimately require a tenant to do, notwithstanding the provisions in the lease, is quite different than what a lender is looking for in a lease. For purposes of financing, it is important that the tenant agree to open (if only for one day), fully stocked and shelved, under the trade name by which the tenant typically employs in the geographic region in which the store is located. Such opening should be on a date certain or at least within a certain number of days after a date that landlord has the ability to control (e.g., the delivery date of the premises). This is particularly important so as to prohibit the tenant from making an argument that it is not in default for failure to open due to the fact that it must only open without a specific timeline.

As previously noted, co-tenancy provisions can also raise a bank's eyebrows in situations such as that described in the prior paragraph. Many tenants insist on a co-tenancy provision whereby a certain number of other stores must be open in order for a tenant to commence paying rent and open and in some cases continue to open and pay rent. For example, if a tenant operating at a center goes dark but continues to pay rent, this may not cause any direct financing issues (e.g., the debt service coverage ratio would still be met). However, if that same tenant's failure to continuously occupy triggers another tenant's co-tenancy clause, thereby allowing that other tenant to cease payment of rent, this could cause financing issues. Ideally in mini-malls, co-tenancy provisions should be heavily negotiated against by the landlord, and if they are included, they should be limited to initial opening and not an ongoing co-tenancy as the loss of even one store in a smaller center could trigger a large percentage decrease in leased space.

While not a requirement, it is also good practice to allow for a recapture option in the event the tenant fails to open or fails to continuously operate. As noted above, the failure to open or continuously operate could create a domino effect with respect to co-tenancies as well as slowing center traffic, thereby causing percentage rent breakpoints to fall short or gross sales termination options to be triggered. While a lender may not focus on this issue up front, it will certainly become a financing issue on the back end.

Conclusion

Of course, there are many other topics that need to be dealt with that are typical to large and small shopping centers, office buildings, apartment buildings and other leasing situations that are not addressed here. For example, the triple net structure of the lease must be clearly spelled out in the lease. To the extent any operating expenses, taxes or insurance are not paid by the tenant (e.g., capital expenses), the owner must make certain that the rent increases take into account this potential increase in cost, otherwise a lender may require the holding of reserves that will adversely impact the amount of equity that the owner must put into the project. Also, throughout the lease negotiations, the landlord should keep in mind that tenant termination rights, however innocuous or unlikely they may be, raise red flags for lenders. It is important that these rights be negotiated out of the agreement, that a landlord have sufficient time to cure, and, most importantly, that the lender receives notice and opportunity (but not the obligation) to cure the default.

Likewise, there are a variety of issues that are common to all shopping centers, apartments, office buildings, industrial parks and other real estate that pertain to financeability of those leases that are not addressed in this article. However, by focusing on the above issues, many of the hot button concerns of both tenants and lenders can be addressed early on to prevent future disputes from arising.