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# THE FLEXIBLE TENANT LEASE

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**CHAPTER 43**

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## I. INTRODUCTION.

In a perfect world, forecasts of sunny skies would always hold true. Unfortunately, forecasts can sometimes prove wrong and those unprepared for the possibility of a storm suffer the greatest. For the commercial tenant, the most well-drafted leases rely on the tenant's best case scenarios for its future leasing needs while also providing enough flexibility for the tenant to weather unexpected problems. No tenant enters into a lease expecting to incur default fees, to encounter difficulties obtaining building permits, or to cease operations. Defaults, delays and setbacks do occur, however, and the tenant with a lease that contemplates these issues will be able to adjust in an efficient and economical manner. Flexibility in a lease can be beneficial to both the landlord and the tenant in that it allows the parties to maneuver through temporary problems and continue an otherwise profitable relationship. There are some scenarios, however, when ending the landlord-tenant relationship is the only viable alternative for the tenant. In those instances, the flexible lease enables the tenant to end its lease obligations with minimal cost and friction.

A lease is "flexible" if it allows the tenant to respond to changing circumstances without encountering onerous lease terms. Barriers to a tenant's ability to adapt can be in the form of rigid deadlines, unpredictable costs, and preventive conditions. This article will examine the ways that a tenant may combat these barriers by incorporating flexible terms into its lease.

## II. CREATING FLEXIBILITY WITH RESPECT TO LEASE TERM.

### A. Commencement Date Issues.

When and how the lease commences and rental payments begin to accrue is an important aspect of any lease. Many landlords want a fixed commencement date so that they know precisely when the rental stream will commence. However, fixed deadlines do not account for unpredictable delays in the tenant's ability to commence operations from the Premises. Generally, a tenant should avoid a fixed date for rental commencement unless any required build out of the space is entirely within the tenant's control and the tenant is certain there will be no delays in the delivery of the space to the tenant.

If the lease requires the landlord to perform certain tenant improvement work to make the space ready for the tenant, then the tenant should attempt to tie the commencement date to the landlord's completion of such work and the issuance of a certificate of occupancy for the premises. (See Appendix 1-A, Option 1.) In these instances, completion of the tenant improvement work must be defined to require that the tenant also have full access to the common areas. If, on the other hand, the landlord has delivered the space to the tenant and the tenant is responsible for its own tenant finish work, then the commencement date should be tied to a certain number of days after the landlord's delivery of the space to the tenant. As a precaution, the landlord will usually require, with justification, that the commencement date actually be tied to the earlier of (i) x days after delivery of the premises to the tenant or (ii) the date tenant actually commences operation of its business from the premises. (See Appendix 1-A, Option 2.)

Obviously, when picking the number of days required for the tenant to perform the tenant improvement work, the tenant should carefully consider all factors that could delay its completion (including, without limitation, potential delays because of weather, shortages of materials, the landlord's failure to timely approve the plans and specifications for the space and the like). In that regard, regardless of whether the landlord or the tenant performs the tenant improvement work, the tenant should make sure that the actual commencement date is subject to delays caused by either the landlord or force majeure events. (See Appendix 1-B.) Often, landlords will delay the tenant's obligation to pay rent under such circumstances without delaying the commencement date of the lease. However, the tenant should ensure that any delay in the obligation of tenant to pay rent as a result of the landlord or force majeure events also delays the commencement date of the lease so that the tenant does not end up with a shorter lease term than was originally contemplated and does not incur lease obligations prior to being able to occupy the premises. Finally, the tenant should have adequate time to move into the space and set up its furniture and systems prior to the commencement date so that the tenant is fully operational from the premises as of the commencement date.

### B. End of Term Issues

1. Renewals

Renewal rights provide the ultimate flexibility for the end of a lease term because the tenant has the right, but not the requirement, to remain in a desirable location. A tenant might want to remain in a good location for a variety of business reasons, including customer familiarity and the avoidance of relocation costs. The lease should clearly lay out the rental payment upon renewal, the length of the renewal, a clear renewal notification process, and a determination of the allocation of tenant improvement responsibility. The deadline for exercising the renewal right should provide the tenant with a reasonable amount of time for the tenant to know whether renewal is the right choice

for its business needs. If the lease provides for a renewal on the original premises, the tenant should also make sure that there are corresponding renewal rights available for any expansion space.

One of the most important terms of a renewal provision is the renewal rental rate. Many tenants have successfully negotiated a base renewal rental rate of 95% of the market rate at the time of renewal, convincing the landlord to give such tenants a discount off the market rate. Landlords are often willing to give such a discount because they are able to save time, hassle and money by renewing an existing tenant rather than finding a new tenant for the space. In any event, the analysis of the market rent as it applies to a renewing tenant should account for the fact that there will be no relocation cost to the landlord, no reconfiguration cost, no or lower brokerage fees, etc. These factors should serve to reduce the market rate for the tenant from that which would be quoted to new tenants coming in.

In the office lease context, a concept which is often missed by tenants resulting in significant increased lease costs relates to the treatment of the base year concept on the renewal of the lease. In most cases, the base rent rental rate will adjust to the market rate upon renewal of a lease. If that is the case, then the base year should also adjust to the year in which the renewal occurs. Otherwise, the tenant will be paying a market rental rate (which includes operating expenses for the year in which the renewal occurs), but will be paying increases in operating expenses over the original base year. In other words, the tenant would be paying for the increase in operating expenses over the base year twice, both in its new base rental amount, and in its additional rent.

2. Holdovers

Landlords understandably do not want tenants to hold over beyond the expiration of their lease term. As a result, landlords will generally increase the tenant's rent during any holdover tenancy to somewhere between 125% and 200% of the last rent paid by tenant during the term. While few tenants enter into a lease with an intention to hold over after the expiration of its term, circumstances may dictate that such a holdover is necessary. For example, the tenant's new space in a different building may not yet be ready for occupancy at the time of the expiration of the tenant's existing lease. Accordingly, the tenant should attempt to negotiate a holdover rent which is as low as possible. Generally, landlords will agree to a holdover rate of between 125% and 150% of the initial term rent.

Many landlords are sensitive to the tenant's plight with respect to holdovers and therefore are willing to allow a short holdover period at a reasonable rate, but will increase the rate as the holdover extends beyond a reasonable period. For example, the holdover rental rate for the first month of a holdover might equal 125% of the previous month's rent, but the rate might increase for each additional month of a holdover, making it more expensive for the tenant to stay in the space. Of course, the landlord would always have its common law remedies to evict a holdover tenant should it desire to do so.

Many landlord form leases also require the tenant to pay any and all damages incurred by landlord as a result of a holdover tenancy. Tenants should attempt to avoid this liability or at least limit its exposure. For example, if the landlord claims that it lost a new tenant as a result of the tenant's holdover, the landlord's claim for damages could be significant. If the tenant is unsuccessful in convincing the landlord to remove this provision from the lease, the tenant should at least limit its exposure to actual (but not consequential, special or punitive) damages.

Finally, most leases provide that a tenant who holds over is occupying the space as a tenancy-at sufferance (which means that the landlord can immediately exercise its remedies to remove the tenant from the premises). Many tenants will attempt to characterize a holdover tenancy as a "month-to-month" tenancy, which will provide the tenant authorized occupancy on a month-to-month basis during a holdover. Sophisticated landlords will reject this idea because it limits their ability to quickly replace the outgoing tenant with a new tenant.

3. Condition of Space at End of Term.

The tenant must be cautious of lease provisions that require the tenant to restore the premises to its original condition at the end of the term. While this provision often remains in a lease unnoticed, it could result in substantial costs to the tenant at the end of the lease term. During the term, the tenant may have installed basic fixtures and other alterations that most succeeding tenants would find useful. If the tenant has plans to make changes that it may want to leave behind, the lease should give tenant that option with respect to those specific changes. If the tenant is making alterations that the landlord will require to be removed at the end of the term, the lease should provide that the landlord must notify tenant of such fact prior to tenant's installation of these alterations.

4. Time to Move Out

Just as the tenant must ensure that it is prepared to begin its business operations from the premises prior to the commencement date, the tenant should also make sure that it gets the full benefit of the entire lease term on the back end of the lease. In that regard, some tenants will attempt to negotiate a certain period of time after the expiration of the lease term (e.g. two

weeks) to remove its property so that the tenant can operate its business right through the end of the term. Obviously, many landlords are resistant to this concept and whether the tenant would be successful in this negotiation is purely a function of its bargaining power.

**C. Early Termination Rights**

Perhaps the ultimate flexibility strategy for the tenant is the contractual right to terminate the lease. Such termination rights are typically linked to the occurrence of certain events or the failure of certain conditions, a prime example in the retail context being a tenant's ability to terminate if it does not reach a specific gross sales goal. Under the right circumstances, however, a tenant may even be able to negotiate an unfettered right to terminate. With respect to the more prevalent conditional termination rights, the tenant should be careful to distinguish between an event or a condition that gives the tenant the right to terminate and an event or a condition that causes an automatic termination or gives both parties the right to terminate. In general, if the event or condition is for the exclusive benefit of the tenant, then the termination right should be at the tenant's sole option (thereby preventing the landlord from causing an event or creating a condition which allows the landlord to exit the lease). If, on the other hand, the event or condition runs to the benefit of both parties (such as a total casualty or perhaps the failure to meet a sales hurdle in a percentage rent lease), then it may be appropriate to have an automatic termination or mutual right of termination.

1. Unfettered Right.

It is rare that a landlord in a typical lease will grant the tenant an unfettered right to terminate the lease at any time and for any reason. Such a provision would likely make the property subject to the lease unfinancable. Under the right circumstances, however, the landlord may agree to give the tenant an unconditional right to terminate on a more limited basis. For example, the landlord may agree that the tenant can terminate at a particular point in time during the lease term, such as at the end of the third year of a five-year lease term. While such a provision may not make the lease unfinancable, landlords and tenants must nevertheless understand that it will certainly affect the underwriting of the lease and, ultimately, the value of the property. As a result, a tenant who presses for a termination right may find itself in the unenviable position of being required to pay a higher rental rate. The tenant must weigh the cost of the termination right against the benefit derived from having such a right.

If the landlord agrees to give the tenant an unfettered right to terminate, the tenant should expect that the landlord will insist on certain requirements relating to such termination. For example, the landlord will probably require that the tenant provide landlord with several months' notice before the termination occurs, so the landlord can begin the search for a new tenant. The landlord may also ask for reimbursement of certain costs associated with the lease, such as the unamortized portion of any tenant improvement allowance paid by the landlord, the unamortized portion of any leasing commissions paid by the landlord and any other concessions or inducements granted by the landlord relating to the lease.

An unfettered termination right also may become much more palatable to the landlord if it is accompanied by some form of termination fee to compensate the landlord (at least in part) for the loss of the rental stream caused by the termination. This termination fee is typically stated in terms of a number of months' rent. Ultimately, the amount of the fee will be a function of the economics of the lease and the underwriting performed by the landlord and, if applicable, its lender. Landlords will generally begin the negotiation asking for a fee equal to the remaining rent due under the lease, but this defeats the tenant's purpose and is not practical given that such a fee may be higher than the amount the landlord would recover if the tenant simply defaulted under the lease. Therefore, the parties usually agree on a fee which is less than the remaining rent payments, but still compensates the landlord at a level that satisfies the landlord and its lender.

2. Failure to Meet Sales Hurdle.

If a retail tenant's business is not particularly successful at the premises, the tenant may require the ability to terminate the lease and discontinue its unprofitable operations. The tenant's right to terminate in this regard is usually tied to the tenant's failure to meet a particular sales hurdle. For example, the lease might provide that if the tenant's gross sales from the premises do not reach $2,000,000.00 during a given year, the tenant will have the right to terminate the lease. It should be mentioned that this right may not be available to every tenant. In fact, this right is most commonly reserved to major national retail tenants who may stretch their demographic requirements to open in a particular shopping center where the outcome is uncertain. In such a case, landlords may be willing to grant the termination right in order to induce the tenant to lease space in the development, believing that the tenant will lend credibility and be a draw to the remainder of the center.

If the landlord is willing to grant a right to terminate based on gross sales, the landlord will usually require certain limitations on such right. First, the landlord will want to clearly define a measuring

period for when the sales hurdle must be met. It may be a one-time right at the end of a certain lease year, or it may be at the end of every lease year. Generally, the landlord will want to wait until the tenant has operated for a few years, because gross sales in the first year may be artificially low. Tenants will generally accept this limitation, because in most cases the tenant would not spend a large sum of money to open a store only to close it in the first twelve to twenty-four months of the lease term.

The landlord also may require that one or more of the following conditions be satisfied before the tenant can exercise its termination right: (i) the tenant must have been operating a fully stocked store during the measuring period (even if the tenant does not have a continuous operations covenant); (ii) the tenant must have been operating for its permitted use only; (iii) the tenant must have been operating in the entire premises; and (iv) the tenant must have used commercially reasonable efforts to meet the sales hurdle. These provisions are necessary to ensure that the tenant does everything possible to make its business at the location successful. The landlord does not want to create a conditional termination right that the tenant can manipulate for its own benefit. Finally, the landlord will also want the right to audit the tenant's gross sales in order to satisfy itself that the sales hurdle has in fact not been cleared.

While a termination right is a powerful tool for a tenant, a tenant which has spent a significant sum of money finishing out its space and stocking its store may not be prepared to terminate its lease if it fails to meet the gross sales hurdle. Therefore, a preferable alternative to termination might be the right to reduce the tenant's rent until the sales goal is met. If the rental obligation is more commensurate with the tenant's actual sales, then both the tenant and the landlord may prefer the tenant to remain in occupancy.

3. Failure of Conditions Precedent.

In some leases, the tenant will want to establish certain conditions precedent to its obligation to perform under the lease, failing which the tenant will have the right to terminate the lease. Such conditions might include anything that would either prohibit or seriously hinder tenant's use of the premises, such as: (i) obtaining the proper zoning classification; (ii) obtaining all applicable licenses and permits (e.g., the liquor license for a restaurant); (iii) obtaining the necessary approvals for the tenant's plans and specifications; and (iv) obtaining a non-disturbance agreement from the landlord's lender. While most of these conditions are not unreasonable, the landlord will want to ensure that the tenant not be placed in a position to create its own right to terminate. As a result, the tenant can expect the landlord to require the tenant to use commercially reasonable efforts to satisfy those conditions which are in the tenant's control. (See Appendix 2 for an example of an early termination provision).

## III. CREATING FLEXIBILITY WITH RESPECT TO THE PREMISES

When a tenant signs a long-term lease, it is often difficult for it to predict what its space needs may be several years into the future. On one hand, the tenant's business may grow exponentially, creating the need for more space than what was originally conceived. Conversely, a down turn in the economy or a merger with another company may require the new tenant to downsize, leaving it with more space than it actually needs. A flexible lease allows the tenant to alter the size of its leased premises to fit its changing space needs.

### A. Expansion Rights

A tenant's resources and operations may not support additional space at the time it executes a new lease. The tenant may, however, have plans for expanding its business and may know at the time of the lease that it will need additional space in the future. Alternatively, a tenant with no plans to expand at the beginning of the lease term may find that expansion is necessary due to unanticipated growth. In either of these circumstances a pre-negotiated expansion right in the lease would help the tenant achieve its expansion with maximum efficiency and minimum cost.

An effective right to expand must provide the tenant with timing flexibility. If the deadline to exercise the option is too early, the option may not be available when the tenant's spacing needs increase. The provision should also be comprehensive enough so that the tenant knows with certainty the new rental payments, the exact location and dimensions of the new space, and the applicable term for the additional space (which would ideally be coterminous with the rest of the tenant's leased space).

### B. Right of First Refusal and Right of First Offer

Although an absolute expansion right into specific space is the ideal solution for a tenant who might need to expand its premises, in many circumstances it is unrealistic to ask the landlord to hold a specific block of space off the market for an extended period of time to provide the tenant an absolute expansion right. Other options exist, however, which may accomplish the tenant's goal without unduly burdening the landlord. The right of first refusal and the right of first offer are vehicles which give the tenant the first rights to lease additional space without requiring the landlord to take the additional space off the market.

A landlord will want the tenant's right of first refusal or the right of first offer to require that the tenant's offer be on exactly the same terms and conditions as was made by the third party or landlord. This stringent standard can complicate the tenant's ability to exercise the right. For example, in the case of a right of first refusal, a party may offer to lease the additional space for a term which continues beyond the tenant's original term of the premises. Therefore, if the tenant elected to exercise the right of first refusal, it would not want to be required to lease the additional space for a term beyond the stated term of its existing lease. In addition, the permitted signage, permitted use, or specific tenant build-out may only be suited for the third party. Finally, the third party's offer could also contain a guaranty or a security deposit that is either unnecessary or impracticable for the tenant. Therefore, to increase the likelihood that the tenant will be able to take advantage of these rights, the language of the lease must be flexible enough to allow the tenant to take advantage of these rights, while still providing the intended economic benefit to the landlord.

### C. Contraction Rights

Just as a tenant must anticipate the potential need to expand, it must also consider the possibility that downsizing might be necessary during the term of its lease. While no tenant ever enters into a lease expecting that it will need to shrink the size of its premises during the lease term, prudent tenants understand that circumstances may exist that make such a contraction necessary. Obviously, the tenant's ability to negotiate a contraction right and the economic consequences related thereto will be a function of the tenant's bargaining power at the time of lease negotiation. However, if a tenant believes that a contraction may be necessary at some time during the lease term, it is in a much better position to negotiate the terms related to a reduction in space prior to executing the lease. If the tenant waits to negotiate a contraction at the time a contraction is necessary, it will be much more costly since the tenant has lost all bargaining leverage at that point.

## IV. CREATING FLEXIBILITY WITH RESPECT TO USE AND OPERATION

Flexibility is also important with respect to the tenant's use and operation of the premises, particularly in the retail context. In the competitive retail environment, tenants must be very quick to change with customer preferences and technology. Therefore, the use and operations provisions of the lease must be flexible enough to change with the tenant's business.

### A. Permitted, Prohibited, and Exclusive Uses

1. Tenant's Exclusive Use Rights.

Often, particularly in retail/restaurant/ entertainment leases, the landlord will grant a tenant the exclusive right to sell its product or service in the development of which the premises is a part. Prudent landlords will grant the exclusive subject to the rights of the tenants already existing in the development and will ensure that any future leases executed in the development will prohibit the tenants under such leases from violating the exclusive. However, many landlords will resist termination as a remedy for the violation of the exclusive, particularly if the breach is the result of a renegade tenant who is breaching the terms of its own lease by violating the exclusive.

If the tenant has the exclusive right to operate and sell its products or services, the probability that the tenant will need to close due to a competitive environment or unprofitable business is reduced. While it is generally in the tenant's best interest to have the exclusive use provision as broad as possible, the provision will generally relate only to the tenant's "bread and butter" offerings. The tenant should expect that the landlord will attempt to narrow this use as much as possible, in order to ensure flexibility in leasing the remainder of the shopping center. In that regard, it is not unusual for an exclusive to carve out a "de minimis" exception which allows other tenants to sell the same product or service as the tenant who holds the exclusive, so long as such offerings are not a significant portion of the business of the other tenant.

The tenant should also expect the landlord to limit the effectiveness of the exclusive to only that period in which the tenant is operating for its permitted use. In other words, if a tenant with an exclusive stops selling the items which are the subject of the exclusive or, worse, goes dark, the landlord will want the ability to lease other space in the shopping center for a use which may overlap the previously granted exclusive. (See Appendix 3 for a sample provision granting tenant exclusive rights).

2. Permitted and Prohibited Uses.

Permitted uses and prohibited uses are essentially two sides of the same coin. Permitted use provisions allow the tenant to perform on the premises the activities on a discrete list. Prohibited uses ban the tenant from engaging in particular activities.

The permitted use provision should be as broad as possible to allow the tenant with as much flexibility as possible. Ideally, the provision would allow tenant to use the premises for any lawful purpose. Most landlords, especially in the retail context, will require that the tenant lease the premises subject to a more narrow permitted use. The permitted use provision,

however, should include activities that are incidental to those named on the list.

Prohibited uses can generally be divided into three categories. First, the landlord will want to prohibit uses which may be deemed to be offensive or otherwise diminish the reputation of the development. The second category of prohibited uses will relate to specific uses which the landlord has granted as exclusives to other tenants in the development. Finally, in the retail context, the landlord may wish to prohibit uses which are not offensive and do not relate to exclusives granted to other tenants, but which may require an unusual amount of parking for extended periods of time (such as, for example, bowling alleys).

Both permitted use provisions and prohibited use provisions may not only create issues for the tenant's use of the premises, but they may also create obstacles to the tenant's right to assign the lease or sublet its interest in the premises. The tenant should request that those provisions be subject to the tenant's right to assign or sublease. The landlord will likely retain the right to review the assignee's or sublessee's intended use. The use restrictions should not, however, apply to the third party without a consideration of whether the same issues that made those restrictions appropriate for the tenant also apply to the assignee. For instance, the lease may contain a prohibited use that benefited another tenant at the time the lease was signed. If that tenant is no longer a part of the development upon the assignment, the assignee or sublessee should not be prohibited from engaging in that use.

**B. Construction and Alterations**

1. Control Over Work.

One way for a tenant to infuse the construction process with flexibility is for it to retain control over as much of the tenant improvement work as possible. Landlords often require the tenant to use the landlord's engineers and architects and to allow the landlord to choose the general contractor. It is possible, however, for tenants to use their own general contractors and construction managers. If tenant is unable to retain control over the construction, tenant should at least require that the landlord solicit competing bids from general contractors.

In most cases, landlords will require the right to review tenant's plans and specifications. This is a reasonable request; however, the tenant should limit any fees charged by the landlord in connection with such review to major alterations (i.e., those which affect the building systems or structures) and the timeline for the landlord to review the plans should also be reasonable.

In addition to the work on tenant's premises, the landlord may also be engaged in construction on the common areas or another tenant's nearby premises. In these instances, the tenant has an interest in reserving the ability to review any work that the landlord may be performing that will affect the tenant's premises so that the tenant can ensure that the landlord's construction will work in conjunction with the tenant's work.

2. Allowance.

The tenant improvement allowance should be governed by a precise process that includes fixed deadlines, a clear approval process for draft requests, and a specific means for computing each disbursement. To allow for the unexpected, the tenant will want a great deal of flexibility in how it can use the allowance. If the tenant has completed the work, there should be no conditions to the tenant's entitlement to the specified allowance amount, other than the landlord's verification of the tenant's expenses and of the work's compliance with the plans and specifications. The parties should also carefully lay out any indemnification, insurance, or payment and performance bond requirements to the tenant's work.

Despite their best efforts during negotiations, the parties may arrive at an allowance amount that does not correspond with the actual construction costs. The landlord will want provisions in the lease to govern any excess costs to construction that are above the amount of the allowance. Namely, the landlord will want no responsibility to pay for costs above the agreed upon allowance. Similarly, the tenant should negotiate to receive the benefit of any allowance that remains after the payment of all costs. The tenant should choose to either require the landlord to pay the tenant the difference between the total actual costs and the allowance, or to reduce the rent by an amount that reflects the landlord's cost savings in not having to spend the full allowance. The right to receive the remainder of the allowance corresponds with the requirement that the landlord obtain bids: if landlord has the right to use its relatively more expensive contractor, it is unlikely that there will be a remainder for tenant to receive in addition to the completed tenant improvement work.

**C. Signage**

A tenant's signage is a key medium for marketing the tenant's brand to its consumer base. The tenant's objective with its signage is always to ensure its sign's effectiveness by preserving its content and its visibility. As a tenant's business model and/or branding changes, its sign may need to change accordingly. A tenant should try to maintain maximum flexibility by providing that it can install such signage, both interior and exterior, as it may in its discretion choose, the only limitation being the sign's compliance with local municipal or other governmental requirements. If the tenant cannot achieve total discretion, it can increase

its flexibility by obtaining pre-approval of its signage. In addition, if the tenant is a national or regional tenant with multiple locations, the landlord may agree to allow the tenant to change its signage in a manner which is consistent with the signage of substantially all of the tenant's other locations. To protect its sign's visibility, the tenant also may require some degree of control over the height of surrounding buildings on the landlord's property.

A tenant must also be aware of how retaining flexibility in it signage impacts its ability to assign the lease. For example, most national retail tenants place a particular emphasis on obtaining approval of their signage package prior to execution of the lease. If a tenant has negotiated the right to assign or sublet the premises, but the landlord has strict approval rights over any signage, the landlord effectively has strict approval rights over the assignment or subletting, because the potential transferee will not agree to move forward until its signage is approved. Therefore, the tenant should ensure that the signage provisions of the lease allow for a change in exterior signage in connection with an assignment or sublease.

**D. Operating Covenants**

A tenant may find itself in a position where it is more advantageous to cease operations and continue to pay rent on a location, than continue operating. In order to accomplish this objective, the tenant must negotiate for the removal of any covenant of continuous operations (or operating covenant) from the lease.

1. Disclaimer of Operating Covenant.

If a tenant wants to ensure that it has no operating covenant requirement, it should specifically disclaim any covenant in the lease. (See Appendix 4 for a sample provision expressly negating a covenant of operation.) However, at a minimum, the tenant should carefully analyze the lease to ensure that no operating covenant exists unless it is expressly intended by the parties. When examining the lease, the tenant should also be aware that operating clauses can be implied in a lease. For instance, an operating clause could be implied when a lease provides for percentage rent and the base rent is nominal.

Except in the retail context, landlords are generally receptive to a request to remove the operating covenant from the lease. However, in the retail context, the failure to have an operating covenant provides an additional advantage to the tenant. If the tenant is happy with its sales from a particular location but has been dissatisfied with the landlord or the shopping center in which it is currently located, the tenant without an operating covenant could close its store and relocate to a newer or better shopping center in the same market area. However, retail landlords are very reluctant to remove operating covenants from their leases because of co-tenancy concerns and the effect a dark store has on the image of and traffic to and from its center. Whether a tenant is successful in removing a covenant of continuous operations is usually determined by the tenant's relative bargaining power.

2. Limited Operating Covenants.

If the landlord insists on some form of operating covenant, then a compromise might be for the tenant to agree to open and operate for a limited period of time, after which the tenant may go dark. This approach at least provides the landlord some comfort that the tenant must spend the money to finish the premises and open and stock the store, but allows the tenant to retain the flexibility to go dark should the need arise in the future.

3. Recapture Right.

If the tenant is successful in negotiating a lease without an operating covenant or with a limited operating covenant, the landlord may insist on a recapture right similar to the one discussed in the assignment and subletting provision of this paper. In this case, the landlord might require the right to recapture the premises if tenant closes its business for more than a specified period of time. The tenant will want to ensure that the recapture provision excludes temporary closures for remodeling, reconstruction after casualty and similar reasons, and that it can void the landlord's recapture right by re-commencing operations prior to the effective date of the termination.

**E. Radius Restrictions**

A radius restriction establishes an area around the premises within which the tenant may not operate a business like the one it has in the premises. From the landlord's perspective, a radius restriction becomes particularly important in a percentage rent lease, because a second location in close proximity to the premises would most likely cannibalize sales from the premises, thereby decreasing the landlord's rental stream. However, radius restrictions necessarily inhibit the tenant's flexibility because they prevent the tenant from operating its business in the manner it deems most effective. If a landlord refuses to delete the provision, a tenant's next objective should be to narrow the scope of the restriction as much as possible. This would include reducing the size of the prohibited area as well as the duration of the restriction. In addition, if the tenant operates multiple lines of business, the restriction should be limited only to the business being operated by the tenant at the premises.

**F. Late Term Repairs**

Leases typically give the tenant the responsibility to make repairs and to perform maintenance for the leased premises during the lease term. A tenant that spends significant amounts of money for a repairs during the last days (or months) of the term will never see the benefit of those expenditures. Essentially, a tenant making these late term repairs is helping the landlord prepare the premises for the next tenant. Many tenants will negotiate an exception to the tenant's duty to repair for costly repairs, not caused by the negligence of the tenant, that occur late in the lease term. As a compromise the tenant might agree to share the cost of the repairs with the landlord pursuant to a sharing formula that recognizes the relative benefit of the repairs to each of the parties.

**G. Insurance Requirements**

Many tenants fail to carefully review the insurance requirements contained in their lease and later find themselves in a position where they have to purchase additional insurance coverage because their existing insurance program does not match the requirements of the lease. The tenant should carefully review (and have its risk manager or insurance agent review) these provisions to ensure first that the requirements are reasonable and second that the requirements match the tenant's existing insurance program or are easily obtainable at little to no cost to tenant.

1. Self-Insurance.

While many tenants may desire to self-insure certain risks, the right to self-insure is not typically included in landlord form leases. Therefore, if the tenant maintains a self-insurance program or contemplates that at some point in the future it may consider one, it should specifically negotiate such right in the lease document. If the landlord is agreeable to a self-insurance right, the tenant should expect certain conditions to and limitations on such right, such as requiring that the tenant maintain a certain level of net worth or provide some form of credit enhancement. (See Appendix 5 for a typical self-insurance clause).

2. Waiver of Claims/Waiver of Subrogation.

Most lease forms contain a provision whereby each party waives any claims it may have against the other with respect to risks which are insured or required to be insured pursuant to the terms of the lease. This is typically followed by a provision requiring such party to also obtain from its insurance carrier a waiver of such carrier's rights of subrogation with respect to such claims. However, if not carefully drafted, these provisions could leave a loophole which might give rise to unanticipated costs. If the tenant has waived a claim it may otherwise have against landlord because the tenant's insurance would otherwise cover such claim, the tenant may still nevertheless be required to pay a significant deductible on its insurance prior to the coverage becoming applicable. Therefore, the tenant should be careful to ensure that any such waiver of claims provision excludes the deductible, since that portion of the claim would not be covered by the tenant's insurance.

The tenant must carefully scrutinize the waiver of claims provision to make sure that it does not conflict with the insurance and indemnity provisions set forth in the lease. The goal of both the landlord and the tenant should be to shift as much risk as possible to the insurance companies in the most efficient manner. However, if the insurance and indemnity provisions allocate risk to one party and the waiver of claims provision allocates that risk to the other, the lease has created an ambiguity which will result in significant delays in settling the claim. To avoid this problem, many leases provide that the waiver of claims provision applies only to the property insurance, thereby allocating the risk with respect to liability coverage via the insurance and indemnity provisions.

The tenant should also ensure that any waiver of claims provision is limited to the extent of the insurance carried by tenant, so that if the insurance limit applicable to any such claim is less than the amount of the claim, then tenant has not waived its right to recover from the landlord the amount in excess of the insurance proceeds.

3. Allocation of Risk.

Usually the lease contains a provision that allocates risk for rent during a period of time when the premises are unavailable due to an event of casualty. If there isn't such a provision, the tenant is essentially self-insuring continued rent payments during that period. A tenant would also be self-insuring any tax payments for the premises during times when the premises could not be occupied. A tenant should consider putting that provision in the lease or purchasing business interruption/extra expense coverage.

**H. Landlord Defaults, Self-Help and Offset**

1. Default by Landlord.

While many landlord form leases fail to contain a landlord default section, tenants should strive to include a provision which provides that upon a default under the lease by the landlord, the tenant has the right to terminate the lease. If agreeable to this concept, most landlords will insist on fairly generous notice and cure provisions for both the landlord and its lender,

which in most cases are appropriate given the severity of the remedy.

2. Self-Help and Offset.

The longer a landlord's default is left uncured, the more damage it can cause to the tenant's operations. Eventually, the tenant may need to address the matter itself and receive compensation from the landlord later. In these situations, the lease would need to provide the tenant with a self-help right. The lease should have a clear notice and curative period for the landlord's default, except in the case of emergencies, so that the tenant is certain when it's ability to cure the default begins. In the case of emergencies, however, a tenant should be able to cure immediately. Landlord may be more likely to grant the tenant a self-help right in the case of a lease of a single tenant building, as opposed to a multi-tenant building. When considering whether to grant a self-help right in connection with a multi-tenant building, the landlord must consider the effect of such a right on the other tenants of the building.

3. Offset Rights.

The ability to grant the tenant the right to cure landlord defaults is one matter; however, the right to offset the cost of such cure against rent is quite another. From the tenant's perspective, if it is required to cure a default of the landlord it wants to make sure that it will be adequately compensated for such cure. In that regard, many tenants will ask for a right to offset the cost of such cure against the rent next coming due under the lease. Landlords are understandably reluctant to grant offset rights, because it has the potential to interrupt the rental stream and create issues for the landlord from a cash flow and financing perspective. One compromise which has been utilized successfully is to only allow the tenant the right to offset the cost of cure against rent after the tenant has obtained a final non-appealable judgment or arbitration ruling justifying the tenant's claim of the landlord's default and acknowledging the landlord's failure to pay the sums required under the lease.

## I. No Build Areas

No build areas prevent a landlord from interfering with a tenant's business by building a buffer around the tenant's premises in which the landlord cannot build. The tenant, particularly in the retail context, will not want the landlord or any other tenant to build in common areas surrounding the premises in ways that impede visibility or access to its location. A tenant that is unable to secure an absolute no build area should attempt to negotiate for the right to review and refuse consent to either the landlord's or another tenant's request to build nearby.

## V. CREATING FLEXIBILITY WITH RESPECT TO TRANSFERS - ASSIGNMENT AND SUBLETTING

Another section of the lease that is critical to maintaining flexibility for the tenant is the assignment and subletting provision. Because the right to assign the lease or sublet the premises is an important exit strategy to a tenant when entering into the lease, the tenant should work hard to preserve as much flexibility in this area as possible. It is extremely important that the tenant pay attention to this provision during the lease negotiation process because most landlord form leases strictly prohibit assignment and/or subletting by the tenant. In addition, under Texas law, if the lease does not provide otherwise, an assignment or sublease always requires the prior consent of the landlord. TEX. PROP. CODE § 91.005 (West 2002).

Landlords are understandably concerned about who is occupying their space and, therefore, will be reluctant to grant the tenant broad assignment and subletting rights. However, in most cases landlords will agree to allow certain limited transfers without their consent and to otherwise not unreasonably withhold their consent to a proposed assignment or sublease, so long as certain conditions are satisfied. This section will discuss the assignment and subletting provision in more detail.

### A. The Right to Transfer.

An obvious tension exists between the landlord and tenant with respect to the tenant's right to transfer. While the tenant will strive for an unrestricted right to assign or sublease, the landlord will want a complete prohibition on transfers without the landlord's consent. Generally, more sophisticated lease negotiations lead to a compromise somewhere in the middle of these two extreme positions whereby the tenant retains the right to assign the lease or sublease the premises without the landlord's consent only in very limited circumstances, and in all other cases the landlord agrees not to unreasonably withhold, condition or delay its consent.

Those circumstances in which the tenant should require no landlord approval for a transfer include (i) transfers to "affiliated" entities (such as corporate siblings, parents or subsidiaries of the tenant), and (ii) transfers which are incidental to a sale of the tenant's business or other corporate transaction (such as the sale of all or substantially all of the tenant's stock or other equity interests, the sale of all or substantially all of the tenant's assets, a merger, consolidation, initial public offering, or similar transaction).

Depending on its bargaining power, the tenant might also consider pressing for the absolute right to transfer to another tenant so long as the transferee satisfies a net worth requirement and other appropriate restrictions. These restrictions will generally relate to

the financial responsibility, character, operating history and proposed use of the proposed assignee or subtenant. In the retail context, the restriction also might relate to the number of stores then being operated by the transferee. These requirements should be objective and quantifiable, so that no dispute will arise in the future. The tenant should therefore avoid requirements that the proposed transferee be "creditworthy" or that the tenant fit in with the "tenant mix" of the shopping center. Instead, the tenant should require that the landlord define what type of tenant the transferee must be (such as a certain type of retailer), or should focus on prohibited uses that such transferee must not be in violation of.

Another issue the tenant should address in the assignment provision is the right to obtain a leasehold mortgage. Changing market conditions may create the need for additional financing. Many lenders will require a lien on the leasehold estate as a condition to the financing. In many jurisdictions, a leasehold mortgage is considered an assignment, and, therefore, will be prohibited under the lease unless the lease specifically allows such a transaction.

**B. Landlord's Consent.**

In situations where the landlord's consent is required for a transfer, the tenant should pay careful attention to the standard used for determining the landlord's discretion. This standard is often set forth in the lease itself, which will provide either that the landlord may withhold its consent in its "sole and absolute discretion" or that the landlord "may not unreasonably withhold, condition or delay its consent." Most courts will give effect to the intent of the parties if such intent is clearly demonstrated in the lease document.

If the landlord agrees to a "reasonableness" standard with respect to its consent, it may nevertheless attempt to define that standard by imposing subjective conditions on its consent. The tenant should be careful to ensure that any attempt to define the "reasonableness" standard does not lead to a more subjective standard on the part of the landlord.

If, on the other hand, the lease fails to provide the standard for the landlord's discretion in providing its consent, courts are split as to whether a standard is implied. In many states, courts will imply a reasonableness standard to the landlord's consent obligation. MILTON R. FRIEDMAN, FRIEDMAN ON LEASES §7.304a (4th Ed. 1997). In Texas, however, courts have held that there is no implied reasonableness standard with regard to the landlord's consent. See Reynolds v. McCullough, 739 S.W.2d 424, 429 (Tex. App.—San Antonio 1987, writ denied). Given the split of authority, it is therefore in both the landlord's and the tenant's best interest for the contract to clearly specify the standard to which the landlord will be held.

**C. Review Costs**

The tenant should also carefully scrutinize review fees charged by the landlord in connection with the landlord reviewing an assignment or sublease request from the tenant. The tenant should attempt to limit any review fees to the actual out-of-pocket costs incurred by the landlord in connection with landlord's attorney's review of the proposed assignment/sublease, with a cap on such expense to ensure that the cost does not exceed what would otherwise be reasonable. Depending on the size of the lease, this fee should typically be limited to the range of $500 to $2,500.

**D. Tenant's Continuing Liability.**

In most cases, the tenant (and any guarantor) will continue to remain liable on the lease after an assignment or sublease, even if the landlord consented to such assignment/sublease. However, in certain circumstances where the transferee is as financially strong as or stronger than the transferor, the landlord may agree to release the tenant (and any guarantor) from liability under the lease. Under Texas law, if the lease is silent on the issue, the assignor/sublessor will remain liable on the lease See Martinez v. Ball, 721 S.W.2d 580, 581 (Tex. App.—Corpus Christi 1986, no writ).

**E. Excess Rent.**

Another issue that often arises during the negotiation of the assignment and subletting provision is the determination of which party will have the right to keep any excess rent paid under a sublease. A landlord will argue that it leased the space to the tenant for tenant to use during the term and that the tenant should not "profit" from the landlord's real estate. The tenant, on the other hand, will argue that the tenant bears the risk of a market decline during the lease and it should also enjoy the benefit of an upswing should it desire to assign the lease or sublet the premises. Since both parties have compelling arguments, this issue is often the subject of a compromise, whereby the parties agree to share in any excess rents. This solution makes sense from both parties' standpoint because if the tenant does not at least share in some portion of the profit from the sublease, the tenant will have no incentive to sublet the premises at the highest rate possible. The landlord, on the other hand, will want the tenant to sublet at the highest possible rate so as not to create the impression that rents in the development are lower than they actually may be. At the very least, tenant should require a clause that the tenant will recover its costs of improving the premises and in

obtaining the assignment prior to sharing any profit with the landlord.

**F. Landlord's Recapture Right.**

Many landlords will reserve the right to recapture the premises if the tenant attempts to assign the lease or sublet the premises. While at first blush this may appear to be an insignificant issue to the tenant (since the tenant is attempting to exit the lease anyway), it can quickly become problematical for the tenant. For example, the tenant may be experiencing a temporary contraction in its workforce, and may want to sublet a portion of its premises for a short period of time until it needs the space again. In such a scenario, a landlord recapture right would prevent the tenant from generating additional revenue from the empty space in its premises through subletting. In addition, recapture rights affect the ability of the tenant to market the premises for assignment or sublease. If a prospective subtenant or assignee knows that the lease contains a recapture right, it may be less willing to spend the time and effort needed to negotiate an assignment or sublease with the tenant. In addition, the recapture right could effectively undermine the agreement between the landlord and the tenant relating to excess rent, because the landlord could potentially exercise its recapture right and turn around and relet the premises to the prospective transferee that the tenant secured. In essence, this results in the tenant becoming the landlord's marketing department.

On the other hand, if the tenant is truly looking to exit the lease permanently, a recapture right may be preferable for the tenant, since the tenant will be released from its obligation under the lease with respect to the space recaptured. Therefore, most tenants will accept a recapture right subject to certain limitations which are intended to address the concerns referenced in the preceding paragraph. First, the recapture right should not apply to transfers to affiliated entities or corporate transfers. In addition, the lease should provide that the tenant can void the landlord's recapture right by withdrawing its request for consent. This allows the tenant to maintain the flexibility it may need with respect to future space needs. In order to keep the landlord honest, the lease should provide that if the landlord waives or is deemed to have waived its right to recapture, the landlord is not entitled to share in any profits or excess rent.

Finally, the recapture provision should provide that the tenant is not required to disclose to the landlord the terms of the proposed assignment or sublease. This protects the tenant from becoming the landlord's "marketing department" by forcing the landlord to decide based on the qualities of the proposed transferee alone, not on the deal being negotiated between the transferee and the tenant. Alternatively, the tenant might attempt to get the landlord to agree that if the landlord elects to exercise its recapture right, the landlord cannot turn around and relet the premises to the proposed transferee offered by the tenant.

**G. Other Lease Provisions.**

The right to assign and/or sublease may be useless if certain other provisions of the lease are not also addressed. As discussed in Section IV(C), restrictions on signage can effectively give the landlord the right to deny an assignment. Additionally, many landlord form leases provide that any renewal rights or options granted to the tenant are personal to the tenant and will not be applicable to any subtenant or assignee. Most assignees or subtenants will not spend the money necessary to finish the space for their use if only a couple of years remain on the lease. Therefore, the space becomes unmarketable for assignment or sublease purposes if the renewal rights or options are not attached. Finally, the tenant must ensure that its potential subtenant/assignee has the ability to make the necessary alterations to the premises for its use. It does the subtenant/assignee no good to have the right to use the premises if it cannot tailor the premises to its use. (See Appendix 6).

## VI. CREATING FLEXIBILITY WITH RESPECT TO LEASE COSTS

**A. Cost of Tenant Improvements**

Often, when a tenant moves into a new premises, significant dollars are spent on tenant improvements required in order to tailor the premises to the tenant's use. Many tenants will elect to pay up front costs of the tenant improvements themselves, while others may elect to have the landlord pay the up front costs of the tenant improvements and amortize such costs over the life of the lease through higher base rent. When negotiating the lease, the tenant should consider its cash position and which method of payment best satisfies the tenant's goals. Obviously, the cooperation of the landlord will be required in this endeavor, and the tenant should address these issues at the commencement of the lease negotiation process in order to ensure that no surprises arise with respect to tenant improvement costs.

**B. Security Deposits vs. Letters of Credit vs. Guaranty**

While mature and highly capitalized tenants are typically a landlord's first choice, a landlord may be willing or required to consider a tenant whose financial condition is less than desirable. In those instances, the landlord will want to reduce the level of risk associated with the tenant with a credit enhancement requirement.

This section will discuss the three major forms of credit enhancement utilized in leases: security deposits, letters of credit, or guaranty.

1. Security Deposits.

Cash security deposits are the most common form of credit enhancement. The tenant secures its obligations under the lease by depositing cash with the landlord or pledging a cash equivalent. The landlord will want to ensure that the security deposit will transfer to the new owner upon the sale of the property and, upon such transfer, the landlord is relieved of all liability. The tenant should condition the landlord's release from liability on (i) the actual transfer of the deposit to the purchaser, and (ii) an express assumption of the landlord's liability with respect to the deposit by the new purchaser. In jurisdictions where state law does not already so require, a tenant should also make sure that the landlord maintains a separate account for the deposit and does not commingle the money with any other funds.

The most significant benefit of the security deposit is the lack of administrative red tape required to provide this form of security. The biggest drawback of this form of credit enhancement is that it ties up the tenant's cash resources. However, one way to eliminate this issue is for the tenant to pledge a cash equivalent, such as government bonds or commercial paper, rather than give an amount of cash to the landlord.

2. Letters of Credit.

A letter of credit is an agreement in which a bank (issuer) is requested by its customer (tenant) to honor a demand for payment by a third party (the landlord) upon compliance with any conditions specified in the instrument. While an issuer may require that its customer post collateral, that amount is often less than the otherwise required cash deposit.

One of the benefits of a letter of credit is that it avoids tying up the tenant's cash. Also, the letter of credit will likely automatically expire at the end of the lease term. This can be a better situation for the tenant than a cash security deposit, in which the tenant sometimes finds itself battling with the landlord several months after the lease has expired in an attempt to have its funds returned. Finally, the letter of credit provides advantages in the event of a bankruptcy by the tenant; however, a discussion of those advantages is beyond the scope of this paper.

3. Guaranty.

With a guaranty, a tenant has a third party act as a surety for the tenant's responsibilities under the lease. The third party is typically the parent or another affiliate of the tenant. In a lease that combines both a guaranty and a security deposit, the tenant should require that the landlord first exhaust the security deposit before enforcing the guaranty.

One benefit of the guaranty is that, like a letter of credit, the tenant does not have to commit cash to secure its lease obligations. The guaranty may be better than providing a letter of credit because it can be obtained with less administrative burden.

### C. Base Rents vs. Percentage Rent

There are two main mechanisms for calculating rent in a retail lease. "Base rent" is typically quoted to tenants on a "per square foot" basis. Percentage rent is a share of the gross sales that are paid to the landlord. The percentage usually applies to the amount above a particular dollar amount in gross sales, the "breakpoint." Percentage rent allows a tenant's rental payments to adjust for changes in economic conditions that affect its income. It also allows for the landlord to share any upside should the tenant's business from the premises be profitable. On the other hand, base rent provides the tenant with a more consistent figure for planning purposes. Careful consideration should be given to the choice between these two methodologies, as one form may be better suited than the other for the tenant's business needs.

## VII. CONCLUSION

When entering into any lease negotiation, the tenant's representative should attempt to provide as much flexibility to the tenant as possible. Flexibility in the lease can save the tenant time and money at a later date when contingencies arise which may not have been fully anticipated. While this article has attempted to address the major areas of a lease in which flexibility is important, there are no doubt other areas in which flexibility would be useful as well. In short, the tenant's representative should enter the lease negotiation with a mindset of "expecting the unexpected". While a tenant will never be able to address all of the potential contingencies in a lease, negotiating the lease from a mindset of flexibility will significantly improve the tenant's position in the lease relationship.

## APPENDIX 1 - COMMENCEMENT DATE

A. Option 1 – "Commencement Date" means the earlier of (i) the date the Tenant actually occupies the Premises for the conduct of its business, or (ii) the first business day of the week following Tenant's receipt of a five (5) business day factually correct notice stating that the tenant improvements are substantially complete and a certificate of occupancy (or its equivalent) has been issued for the Premises.

Option 2 – "Commencement Date" means the earlier of (i) the date that Tenant actually occupies the Premises for the conduct of its business, or (ii) the date which is ninety (90) days after Landlord's delivery of the Premises to Tenant.

B. Notwithstanding anything to the contrary as set forth herein, if any actual delay shall occur in the completion of the Work to the extent and as a result of:

(a) any delay in any of the dates set forth in this Tenant Improvements Agreement (including, without limitation, the Space Plan Date, the Plan Delivery Date, the Contractor Submission Date and the Contractor Selection Date), to the extent caused in full or in part by any delay on behalf of Tenant or any Tenant Related Party,

(b) any occurrence described in the definition of Change Costs,

(c) Work that is non-Building Standard that requires a lead time (not due to a Landlord default or error) to obtain materials or construction time to perform in excess of that required for Work which is Building Standard or which would be normal and customary for general business office purposes, as reasonably determined by Landlord, or

(d) any other act, omission, delay or default of Tenant or Tenant's agents, representatives or employees or the Construction Manager, including any violation of the provisions of the Lease or any delay in giving authorizations or approvals pursuant to this Tenant Improvements Agreement, then any such delay shall be considered a Tenant Delay and will be subject to the terms of Section __ of the Lease.

No Tenant Delay shall be deemed to have occurred unless and until the Landlord has provided written notice to the Tenant specifying the action or inaction that Landlord contends constitutes a Tenant Delay. If such action or inaction is not cured within one (1) day after receipt of such notice, then a Tenant Delay, as set forth in such notice, shall be deemed to have occurred commencing as of the date such notice is received and continuing for the number of days the construction of the Tenant Improvements was in fact delayed as a direct result of such action or inaction.

C. Upon completion of the tenant improvements, Landlord and Tenant shall re-measure the Premises to determine the rentable area of the Premises in accordance with BOMA Z65.1-1996 Standards and if such re-measurement yields a rentable area that is lower than _____ square feet, then Base Rental shall be adjusted downward to reflect an annual rental rate of $_____ per square foot of rentable area in the Premises.

## APPENDIX 2 - EARLY TERMINATION RIGHT

Section _____. Termination Right.

(a) Tenant shall have the one (1) time right to terminate (the "Termination Right") this Lease effective on the date (the "Early Termination Date") which is _____ (__) months after the Commencement Date, provided each of the following conditions has been satisfied: (i) Tenant has given Landlord written notice (the "Termination Notice") of such termination at least _____ (__) days prior to the Early Termination Date and Tenant is not in default hereunder at the time Tenant gives such notice to Landlord or at any time thereafter prior to the Early Termination Date; (ii) Tenant has been engaged in the normal operation of its business during the twelve (12) months immediately preceding Tenant's notice of termination and Tenant's Gross Sales for such period were less than $_____ (provided that such figure shall be reduced by 1/360th for each day Tenant was not engaging in the normal operations of its business due to an event of force majeure), as evidenced by a statement of Gross Sales conforming with the requirements of Section ____ to be delivered concurrently with the Termination Notice; and (iii) Tenant has paid to Landlord, on or before the Early Termination Date, the sum of the following: (A) the unamortized value of Landlord's Contribution (as hereinafter defined), amortized over the Original Term, (B) the unamortized value of commissions paid to Broker by Landlord in connection with this Lease, amortized over the Original Term, and (C) a termination fee in an amount equal to _____ (__) months of Base Rent and _____ (__) months of the other amounts owed by Tenant to Landlord under this Lease (in each case, for the _____ (__) month period immediately preceding the Early Termination Date).

(b) In the event Tenant exercises the Termination Right pursuant to this Section ____, Tenant shall vacate the Demised Premises no later than _____ (__) days after the Early Termination Date. Tenant will remove all of Tenant's Fixtures and Equipment (as hereinafter defined) and Tenant will, at its own cost and expense, repair any damage that Tenant may cause to the Demised Premises by such removal.

(c) Landlord's and Tenant's obligations which have accrued under this Lease prior to the Early Termination Date shall survive the termination of this Lease.

(d) In the event Tenant fails to surrender possession of the Demised Premises no later than _____ (__) days after the Early Termination Date, Tenant shall be subject to Section ____ hereof *[insert section reference to the lease's holdover provision]*.

(e) Upon Tenant's performance of each of the obligations contained in this Section ____, neither Landlord nor Tenant shall have any further obligations or liabilities under this Lease, except for those which by their express terms survive termination of the Lease.

(f) Landlord shall have the right to audit Tenant's statement of Gross Sales for such period within ninety (90) days of Landlord's receipt of Tenant's termination notice hereunder, and Landlord shall provide Tenant with the results of such audit. If Landlord's inspection or audit reveals that Tenant's Gross Sales are in excess of the amount required for the exercise of the Termination Right, then Tenant shall have the right to contest such audit or inspection. If Landlord and Tenant each dispute the other's findings, then Landlord and Tenant jointly shall elect an independent auditor to determine the actual Gross Sales for the relevant period. The costs of the third-party audit shall be borne by the non-prevailing party. In the event the independent auditor determines that Tenant's Gross Sales were understated to the extent that Tenant is not entitled to exercise the Termination Right, then Tenant's termination notice shall be withdrawn and this Lease shall continue in full force and effect. All audits and inquiries performed by or on behalf of Landlord (including the third-party audit) must be completed prior to the Early Termination Date.

## APPENDIX 3 - EXCLUSIVE PROVISION

Section ____. Tenant's Exclusive Use.

(a) Landlord must not operate, lease, or permit any other store located within the Shopping Center or any other property owned or leased by Landlord within a one (1) mile perimeter of the Shopping Center (the "Restricted Area") to be used for the sale of _____ ("Tenant's Exclusive Items"), so long as Tenant is operating a store at the Demised Premises which sells such items. This covenant runs with the land comprising the Shopping Center. Landlord agrees to enforce this restriction against all other tenants of the Restricted Area using reasonable legal means. Notwithstanding the foregoing, the restriction contained in this Section ____ does not apply to the ancillary sale of Tenant's Exclusive Items by any occupant of the Restricted Area in an area not to exceed the lesser of 500 square feet of floor area or 5% of such occupant's floor area.

(b) If any tenant or occupant of the Restricted Area violates the foregoing Tenant's exclusive, then Tenant, in addition to all other remedies available at law or in equity, may have the right exercisable by written notice to Landlord to either (i) terminate this Lease or (ii) reduce its obligation for Base Rent, Percentage Rent, and Additional Rent to fifty percent (50%) of the Base Rent otherwise required to be paid by Tenant ("Reduced Rent"), which Reduced Rent will be retroactive to the date the violation of Tenant's Exclusive commenced and will continue until such violation is remedied. Notwithstanding the foregoing, if the violation was not due to the act or omission of Landlord, Tenant must forbear from exercising its right to terminate this Lease for up to ____ (__) days from the date Tenant notifies Landlord of such violation, provided that Landlord undertakes immediate action to stop the violation of Tenant's Exclusive. If the violation does not cease after such ____ (__)-day period, the Tenant will have the ongoing right (in addition to the remedy listed in clause (ii) of this Section ____(b)) to terminate this Lease on thirty (30) days' notice to Landlord. At such time as the violation of Tenant's Exclusive ceases, and provided Tenant has not terminated this Lease, Tenant must resume payments of regular Base Rent, Percentage Rent, and Additional Rent then applicable under the terms of this Lease.

## APPENDIX 4 - OPERATING COVENANT

Section ___. No Express or Implied Covenant of Continuous Operation. Nothing set forth in this Lease shall be construed, in any manner whatsoever, as an express or implied covenant on the part of Tenant to commence business operations or to thereafter continuously operate any business operations on the Demised Premises, and Landlord specifically acknowledges that there is no covenant of initial or continuous operation on the part of Tenant, express or implied. In that regard, it is hereby expressly agreed that Tenant shall have no obligation (i) to initially open for business upon the Demised Premises, or (ii) to continue any business operations at the Demised Premises for any specific period of time. In the event Tenant does not initially open for business at the Demised Premises on or before , 20__, or if (once open) Tenant thereafter ceases Tenant's business operations for a period of twelve (12) consecutive months or more (excepting temporary closings for remodeling, alterations or restoration work and further excepting Tenant's closing business operations in conjunction with an assignment or subletting permitted under this Lease), neither such event shall be deemed to be a Tenant Default, but Landlord shall, after the occurrence of either such event and following the aforesaid date for opening of business or the expiration of any such twelve (12) month period (as the case may be), have the option in either such event of recapturing the Demised Premises and terminating this Lease pursuant to the further provisions of this Section ___ hereinbelow. If Landlord elects in either such circumstance to terminate this Lease and recapture the Demised Premises, Landlord shall provide Tenant with no less than sixty (60) days' prior written notice of such election, which notice must be given, however, prior to Tenant's commencement or resumption (as the case may be) of business operations at the Demised Premises. Upon any such recapture and termination, Tenant shall be relieved of and from any and all liability or obligation to Landlord. During any such sixty (60) day notice period, however, Tenant shall have the option of continuing this Lease (and negating any such notice of recapture and termination of this Lease by Landlord) by notifying Landlord within such period of Tenant's bona fide intent to commence or resume business operations at the Demised Premises (provided such commencement or resumption of business operations occurs within one hundred eighty [180] days after such sixty [60] day period).

## APPENDIX 5 - SELF-INSURANCE

**COMMENT: Sometimes, tenants request the ability to self-insure. This request should be granted only for large, creditworthy tenants and then, only if the risk manager for the project has approved such self-insurance. If the ability to self-insure is approved by the risk manager and the asset manager, the following provision may be inserted in the Lease:**

Section ___. **Tenant's Self-Insurance**. Tenant may provide self-insurance in lieu of the insurance required in Section __, whether by the establishment of an insurance fund or reserve to be held and applied to make good losses from casualties, or otherwise, which conforms to the practice of large corporations maintaining systems of self-insurance. As a condition to establishing a self-insurance plan in lieu of the insurance provided in Section __, Tenant shall deliver to Landlord the following (collectively, the "Self-Insurance Documents"): (1) a certificate of an independent actuary or other independent, qualified person reasonably acceptable to Landlord stating that the self-insurance plan is adequate to provide the protection of the insurance policies described in Section __; (2) a balance sheet as of the end of the most recent quarter of the then-current fiscal year of Tenant (or, if the first quarter in such fiscal year has not expired, the last quarter of the previous fiscal year), prepared by a national firm of certified public accountants (reasonably acceptable to Landlord) in accordance with generally accepted accounting principles consistently applied ("GAAP"), accompanied by such accounting firm's unqualified opinion that the Tangible Net Worth of Tenant exceeds $_____; and (3) a letter (a "Compliance Letter") certifying that, to Tenant's best knowledge, such information is true and correct in all material respects as of the date stated, there has been no material adverse change in the financial condition of Tenant since such date, and there are no lawsuits pending (individually or in the aggregate) which, if adversely decided, could reasonably be expected to have a material adverse effect on Tenant's financial condition. Thereafter, Tenant shall deliver to Landlord as soon as available (and in any event within 45 days) after the end of each fiscal year, a balance sheet for such fiscal year, prepared by a national firm of certified public accountants (reasonably acceptable to Landlord) in accordance with GAAP, accompanied by such accounting firm's unqualified opinion that the Tangible Net Worth of Tenant exceeds $_____, together with a Compliance Letter. If at any time Tenant's Tangible Net Worth is less than $_____ or if the contents of the Compliance Letter is not reasonably satisfactory to Landlord, then Tenant shall be required to immediately obtain and maintain the insurance provided for in Section __. If Tenant self-insures any of the risks to which coverage is required under Section __, Tenant's self-insurance program shall be amended to include the waivers of subrogation and the additional insured status mentioned above in favor of Landlord and its agents and affiliates. Furthermore, (a) the self-insurance protection shall be equivalent to the coverage required above and Tenant shall not be relieved from the indemnification obligations of this Lease, and (b) the Self-Insurance Documents shall indicate the additional insured status mentioned above as well as the waivers of subrogation, and shall state that Landlord will be notified in writing 30 days prior to cancellation or material change of such self-insurance program. If Tenant fails to comply with the requirements relating to self-insurance and insurance, Landlord may obtain such insurance and Tenant shall pay to Landlord immediately on demand the premium cost thereof. It is expressly understood that the self-insurance permitted above does not relieve Tenant of its statutory obligations under the Texas Workers' Compensation Act. If Tenant self-insures under this Section __ and is obligated to defend Landlord under any provision of this Lease, Landlord shall have the right to engage separate counsel for its defense at Tenant's expense, and Tenant shall pay, as incurred from time to time, Landlord's attorneys' fees and expenses (including, without limitation), expert witness fees) relating to Landlord's defense. As used herein, "Tangible Net Worth" means the excess of total assets over total liabilities (in each case, determined in accordance with GAAP) excluding from the determination of total assets all assets which would be classified as intangible assets under GAAP, including, without limitation, goodwill, licenses, patents, trademarks, trade names, copyrights, and franchises.

## APPENDIX 6 - ASSIGNMENT AND SUBLETTING

Section ____. Except in the case of Permitted Transfer, in the event that the rent and other consideration due and payable by a sublessee or assignee under any such permitted sublease or assignment exceeds the Rent for the portion of the Premises so transferred, then Tenant shall pay to Landlord, as additional Rent, fifty percent (50%) of all Profit (hereinafter defined) received in connection with such sublease or assignment, immediately upon receipt thereof by Tenant from such transferee. For purposes of this paragraph, "Profit" shall mean the amount by which all rent and consideration due and payable by any sublessee or assignee under any such sublease or assignment exceeds the Rent payable hereunder with respect to the portion of the Premises so transferred (the "Transferred Space"), after deducting in connection with such sublease or assignment for (i) commercially reasonable broker's commissions paid by Tenant with regard to the transfer, (ii) reasonable legal fees paid by Tenant with regard to the transfer, (iii) commercially reasonable expenses of finishing out or renovation of the Transferred Space involved [but specifically excluding any charges payable to partners, shareholders or employees of Tenant in connection with such sublease or assignment]; (iv) any improvement allowance or other economic concession (planning allowance, moving expenses, etc.), paid by Tenant to sublessee or assignee; (v) lease takeover payments; (vi) costs of advertising the space for sublease or assignment; (vii) any other costs actually paid in assigning or subletting the Transferred Space or in negotiating or effectuating the assignment or sublease; and (viii) the Review Fee; provided, however, under no circumstances shall Landlord be paid any Profits until Tenant has recovered all the items set forth in (i) through (viii) for such Transferred Space, it being understood that if in any year the gross revenues, less the deductions set forth in (i) through (viii) above (the "Net Revenues"), are less than any and all costs actually paid in assigning or subletting the affected space (collectively, "Transaction Costs"), the amount of the excess Transaction Costs shall be carried over to the next year and then deducted from Net Revenues with the procedure repeated until a Profit is achieved. In the event of an assignment, then as long as Landlord shall be entitled to receive a portion of the Profits, the payment of Rents shall be paid to Tenant. Provided however, Tenant shall upon request by Landlord, provide Landlord with an assignment of all Rents in excess of the amount of Profits Tenant is entitled to retain and shall execute any documents reasonably requested by Landlord to effectuate such assignment.