Thursday, October 9, 2025
8:00 AM – 9:00 AM

Core Concepts 3

Economic Terms in Leases: Show Me the Money!

Presented to

2025 ICSC+U.S. LAW
Marriott Marquis San Diego Marina, San Diego, CA
October 8-10, 2025

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The commercial real estate market across all sectors in the United States was valued at $22.5 trillion as of the end of 2023. The reason any particular piece of commercial real estate has value is that somebody needs it for the conduct of business and thus is willing to pay for it. Sometimes, a company will buy the real estate it needs. In the majority of cases, however, this is either not feasible or not efficient. Thus, companies will lease their real estate from someone else who either bought it and built the improvements or bought it with existing improvements. This discussion will focus on the latter, commercial real estate leasing, and retail leasing in particular.

From a real estate investor's perspective, the value comes from someone paying rent, presumably enough to give the investor a decent and reliable return on its investment. There is a general tendency to focus on large anchor tenant leases which involve well-known tenants and largely drive the development of new shopping centers. However, every single lease has value to a landlord. Take a small shop lease where the tenant is paying $6,000 in minimum rent per month - $72,000 per year. Depending on then-applicable capitalization rates and the sophistication level of the underwriting (topics for another discussion), on a sale or financing of this asset, such lease could add $1.0MM to $1.5MM to the purchase price – not insignificant. Multiply that over several smaller spaces in the shopping center and you have a great deal of value.

The retail tenant wants the certainty of knowing it has the location tied up from which it can build a reliable customer base, knowing what it will pay for the real estate over the term, and knowing it can operate the way it wants to, so that it can accomplish one thing - sell its stuff, whether that is goods, services, food, or entertainment. While the dollars that change hands under a lease up front are far lower than the price that would be paid to purchase the asset, a commercial real estate lease is a far more complicated document than is a purchase and sale agreement. Purchase agreements take on all forms and levels of complication, but generally (not a hard and fast rule!), once the closing occurs and the real estate changes hands, the transaction is over. A lease, on the other hand, whether it be for a small space or a large space, allocates all the benefits and burdens of ownership – all the rights and obligations – between the landlord and the tenant. It endeavors to anticipate everything that could happen, and in each case answers two basic questions: Who is obligated to do what, and when? Who is obligated to pay what, and when?

As real estate lawyers, our job is to work through all of these topics and document them in a lease. The goals are twofold. First, to negotiate the most favorable deal for the client. Second, to be clear in drafting so that there is little or no room for dispute as to what the particular provision says. No offense to our litigator friends in the room – we need them when disputes arise – but in my experience, once something goes to litigation, even if your side "wins" you lose, and so does the other side. The goal for the landlord is to make money from its shopping center. The goal for the tenant is to operate its business and make it succeed. Litigation is a huge distraction from each of these goals, consuming vast amounts of time, money, and mental energy -resources that could be better spent on each side running its business. As lawyers, we cannot anticipate every scenario and everything that could go wrong, but we need to strive to be as clear as possible in documenting what the parties agreed to. Also, there is a tendency to assume everything will go generally as planned. True, there may be provisions of a lease which the parties never have to read again. Thus, we rightly focus on the terms we know will be read and implemented by the parties, such as the term, rent commencement, the amount of rent, CAM charges, tenant improvement allowances, etc. However, if you do this long enough you will eventually see everything happen. You will see once dominant tenants – the so-called "category killers" – go bankrupt and disappear or be relegated to a far lower status. You will see disputes arise over all sorts of lease provisions - percentage rent and CAM audits, use rights, exclusives. You will see huge changes how shopping centers are developed and operated. You will see major casualties. You will see condemnations. You will see force majeure events. Who, in negotiating a lease in 2019, would have predicted that a virus that originated in China would cause a shutdown of most of the entire world – including the retail world? The point is that, while it may be human nature to focus on the positive, as lawyers we need to pay attention to every provision of a lease, because if the unexpected situation arises and your client calls us, we need to be able to answer the questions of who is obligated to do what, and when, and who is obligated to pay what, and when, and were those decisions made on an informed basis or in a haphazard manner.

One additional general principle is that the lawyers need to guard against losing perspective. It is doubtful that too many landlords and tenants "enjoy" negotiating leases – it's not the Olympics. It is an expensive, time-consuming, and often frustrating process. The real estate lawyer's job is to delve into the details and minutiae of a lease and hash through each concept, but also to understand that in the end it is a business deal, and the economics matter, and thus, to make sure he or she understands the economics of the deal. That should always serve as the overarching guide to the lease negotiation process.

MINIMUM RENT. This may also be referred to as "base rent," "monthly rent," 'monthly minimum rent," "annual rent," or any derivation thereof. This is the key factor in creating value for the landlord, and is where the landlord derives its profit from the shopping center. With the exception of percentage rent, the other amounts payable by tenants

are generally intended to be reimbursements of actual costs the landlord has incurred and are not intended to be "profit centers."

Establishing the Rental Amount. A lease may contain a complete schedule of the minimum rent to be paid throughout the term, or it may set forth an initial rental amount and provide for percentage increases at certain intervals. From the practitioner's perspective, it is preferable that the client calculate the rents that are payable over the term and provide them to the lawyer. Does the client really want to pay the lawyer several hundred dollars per hour calculating the annual and monthly rents payable over the course of the lease terms and putting them into a schedule in the lease? Nevertheless, the lawyer is often tasked with doing this, and we quickly realize that there is no clear rule as to how rents are to be calculated. For example, the letter of intent may provide that rent is $20 psf and goes up 3% per year throughout the term. If you calculate the rental increases based on $20, you will get slightly different figures than if you multiply the $20 by the square footage then calculate the percentage increases. If you calculate the increases based on 1/12 of the annual rent you will also get slightly different figures. Also, at the time a lease is signed you may not know the actual square footage of the premises, and the lease may contain a remeasurement right on the part of either or both parties. Thus, a schedule of rents set forth at the outset may change in a meaningful way. At the outset of the negotiation, the lawyer should confirm with the client how the client wants to characterize the rent in the lease.

Rent Commencement. In almost every retail lease, there is some lag time between when the landlord delivers the premises to a tenant and when the tenant starts paying rent. The lease needs to be clear as to what triggers a tenant's obligation to start paying. Typically, this obligation commences ____ days after delivery or when the tenant first opens for business in the premises, whichever is earlier. However, often other factors come into play, such as triggering these dates off of the date on which a tenant obtains permits for its work. A landlord will want an outside date and/or the right to take over the process if it believes that the tenant is not being diligent in pursuing such permits. Note that in some anchor tenant leases, there are "blackout periods" during which a tenant is not obligated to open (typically part of November and December), so the landlord will need to consider the timing of its delivery obligations as it relates to the tenant's blackout period. Also, there are often incentives for the tenant, such as free rent for a certain period of time. A landlord should consider if there is a tenant default whether such rent should be recoverable by the landlord in a lawsuit.

PERCENTAGE RENT. In addition to minimum rent, a landlord might be entitled to a percentage of a tenant's sales. In essence, the landlord shares in the tenant's success at the subject location. Though not common, some lease deals provide for straight percentage rent and do not include any minimum rent. You might find this in leases for concessions in specific locations, such as airport terminals. The far more common approach is for percentage rent to be calculated based on the tenant's sales over and above a certain threshold. This threshold is referred to as the "breakpoint." A breakpoint can be an "artificial breakpoint," which is fixed amount: Landlord shall receive percentage rent equal to "X%" of Tenant's gross sales to the extent they exceed "$Y" over the course of a specific time period, usually a year. A breakpoint can also be a "natural breakpoint," which breakpoint is determined by dividing the annual minimum rent by the percentage rent rate. If annual minimum rent is $100,000, and the percentage rent rate is 5%, the natural breakpoint would be $2,000,000. It may be helpful to think of a natural breakpoint as a pure percentage rent deal – landlord gets 6% of all the tenant's sales – except that regardless, the landlord gets a base rent, just in case the tenant's business is not as successful as anticipated. Percentage rent provisions of a lease must address several items. First, it must set forth how gross sales are determined. All sales are added up, but then typically a long list of items are excluded, such as returns of merchandise, sales taxes, credit card fees, and sales to employees at a discount. These exclusions are not difficult to justify, because the tenant arguably is not profiting from them. However, a current topic of much debate centers around internet sales. Do gross sales include items ordered on the internet but picked up in the store? Do gross sales include items ordered at the store but not in inventory, to be shipped later? Often a tenant's accounting system will not separate these items out. Much negotiation – and argument - goes into this topic. Second, when percentage rent gets paid. Some leases provide that percentage rent starts getting paid monthly once the breakpoint for the year is first reached. Within some months after the end of the year, a reconciliation is performed to adjust the gross sales figures reported throughout the year to reflect all factors, such as returns of merchandise. Other leases simply obligate a tenant to pay gross sales after the year is over in a lump sum payment. This may be more appropriate for larger financially strong tenants that for smaller tenants. Note that percentage rent is typically calculated on a calendar year, but any twelve-month period during the year can be used. Also, "stub years" at the beginning and end of the lease term need to be addressed, typically be prorating the breakpoint for such partial year. A landlord will want an audit right to confirm that a tenant's gross sales reporting is accurate. The tenant will want some guardrails around this right, such as an outside date by which the landlord must conduct the audit. Since percentage rent by definition is calculated on a "looking back" basis, the lease should contain survival provisions so that, after the lease expires or

is terminated, the parties' respective rights and obligations will remain in effect until the final percentage rent is paid and/or reconciled.

ADDITIONAL RENT. Though not common in the retail world, except for perhaps leases for very small space, a lease can be a "gross lease" in which the tenant pays a set amount and nothing more. The landlord, in coming up with such rental figure, has taken into account all of the costs it incurs each year to own and operate the shopping center and presumably figured that in to the rental amount. More common, however, is a modified "NNN" lease here many of the costs of operating the shopping center are passed through to the tenant on a percentage basis. The tenant's "pro rata share" of such costs are usually based on the percentage of the square footage of the tenant's premises as compared to the total square footage of the shopping center. As in everything else in a retail lease, there are many variations on this concept. For example, a large anchor tenant or a ground lease tenant may pay based on land area rather than building area. Or a large tenant may pay a fixed amount, leaving the landlord to allocate the rest of the costs over the balance of the shopping center. Sometimes the allocation is bifurcated – a ground lease tenant pays based on building area for common area maintenance expenses and insurance, but does not participate in real property taxes for the shopping center, but instead pays the taxes payable for its specific parcel. Overall, the goal for the landlord is recover the costs exceeding the amount it is entitled to recover from tenants under the leases. The goal for the tenant is twofold – to pay only its appropriate share of these "pass through" costs, and to give the landlord incentive to keep these costs down. Additional Rent generally is divided into three separate categories. The lawyers for both the landlord and the tenant must take care to not gloss over how a tenant's pro rata share is calculated so that it makes sense for each category of expense, and takes into account how expenses are calculated throughout the shopping center.

Common Area Maintenance Expenses. Often referred to as "CAM Expenses," CAM Costs," "Operating Expenses" (though that term is more commonly used in the office leasing context), or just "CAM." These are generally the costs incurred by the landlord to keep the shopping center in good, clean, and operational condition. Lighting, fixing potholes in the parking lot, collection of trash from the common areas, landscaping, security. These amounts can be established in the lease with fixed increases, or they can be based on the landlord's actual costs. Each lease will include a long list of exclusions from these costs which will be the subject of extensive negotiation, such as to what extent, if any, can a landlord pass through capital improvements? Capital repairs (such as resurfacing the parking lot)? Tenant's typically want these to be capped at a certain amount, but landlords will typically exclude form the cap items over which the landlord has little or no control, such as governmentally required repairs or upgrades, real property taxes, insurance costs, and perhaps security costs. Note that a cap on CAM costs will often include "cumulative" or "noncumulative" language, or "cumulative and compounded" language. If increases are capped at 3% per year, and in a year they go up less than that, can that amount below the cap be recovered in future years? Though commonly used, there is often much debate over what these terms actually mean, so it may be advisable for all parties if an example is included in the lease.

Insurance Expenses. Leases vary on which insurance a landlord will carry as compared to what a tenant carries. Most commonly, a landlord will carry liability insurance covering the entire shopping center and casualty insurance (so-called "Special Forms") covering the buildings and other improvements in the shopping center, while the tenant will carry insurance covering its own fixtures and equipment and its one inventory. Much detailed negotiation can go into these provisions depending on the scope and nature of the tenant improvements. It is thus advisable that each party send the insurance provisions to its insurance provider(s) sooner rather than later in a lease negotiation so that all these thorny questions can be worked out. However, the landlord's insurance expenses are generally passed through to tenant's on a *pro rata* basis, and such costs are generally excluded from any caps on CAM expenses. Just like CAM expenses, one must be mindful of how the tenant's pro rata share is to be calculated for the specific shopping center.

Real Property Taxes. Real property taxes are generally a straight "pass through" to tenants, with the caveat that the lease must take into account any premises that are separately assessed and pay real property taxes separately. The timing of payments needs to be considered. In some cases, a landlord will pay real estate taxes when actually due but charge the tenants monthly based on estimates, but in other cases (especially with larger tenants), the tenant pays its share of property taxes are paid in a lump sum at the time the landlord receives the tax bill. Sometimes larger tenants pay its taxes directly to the taxing authority and provide evidence of such payment to the landlord. In certain jurisdictions, such as California, a point of negotiation is the so-called "Prop 13 Protection," whereby a landlord is limited in terms of what increases in real property taxes resulting from a sale of the asset can be passed through to the tenant. Like other forms of pass-through expenses, the methodology of calculating pro rata share is important.

Audit Rights. Similar to a landlord's wanting the right to audit gross sales for percentage rent purposes, a tenant will want the right to audit the landlord's calculation of CAM expenses, insurance expenses, and taxes. As

always, the scope of these rights (if they are included in the lease in the first place) depends on the relative bargaining power of the parties. A landlord will want a limited time frame for a tenant to exercise such right so that it is not, for example, asked to review its books from 5 years before. A landlord will also want to ensure that the party conducting the audit is not being paid on a "contingency" basis, thus giving it added incentive to find discrepancies or to create issues. If CAM and other expenses are paid on a fixed basis, or if annual increases are capped, then there may be no need for the tenant to have an audit right.

Beware of the Terminology Used. Many leases include language to the effect that "all amounts payable by tenant under this lease, other than minimum rent, shall be referred to herein as "Additional Rent" or "Rent." While this concept is useful and is appropriate in many instances, take care that it does not lead to unintended consequences. For example, if a casualty occurs and the premises cannot be occupied, it may be entirely appropriate for the tenant's obligation to pay minimum rent, CAM expenses, insurance expenses, and real property taxes to abate until the premises can once again be occupied. However, if a tenant has some other monetary obligation to pay to the landlord, such as reimbursement for certain improvements that that landlord paid for, reimbursement for some damage to the premises or the common area that the tenant caused, or an indemnification obligation, that is not the type of payment what would typically be abated. What is the result if the lease provides that all "Rent" is to be abated if "xyz" happens. Thus, the types of payments a tenant typically makes to the landlord, such as minimum rent, CAM expenses, taxes, and insurance, should be defined separately from "all amounts which may be payable by the tenant under the lease."

TENANT IMPROVEMENT ALLOWANCES. As in all aspects of life, in retail, there is no "one size fits all." Whether it's new construction or repurposing of space, most leases will require some work to be performed in the premises before it is suitable for the conduct of the tenant's business. Even if the landlord performs the work (a "build-to-suit"), the landlord typically will want a cap on its costs to do the work, with the tenant being responsible for any excess costs. Regardless of which party is responsible to perform the work, many tenants do not have the capital up front to perform this work, or if they have the capital, they have determined that their money can be better used expanding their business elsewhere – opening more stores. Thus, they prefer that the landlord pay for the work up front and charge more in rent. A tenant improvement allowance is an amount, usually a fixed amount or an amount up to a specified cap, which the landlord will contribute to the tenant's work. Think of it as the landlord loaning the money to the tenant and getting paid back over the term of the lease. It is usually stated as a per square foot figure, although it can also be a fixed amount. The key factors relating to a tenant improvement allowance that need to be addressed are as follows. First, the total amount of the allowance needs to be established. Second, the timing of disbursement of the allowance needs to be agreed upon. Is it paid in stages during the performance of the work, e.g., on a percentage completed basis, or is it paid all at the end? Third, the conditions to payment need to be established, such as architect's certification, governmental permit signoffs, as-built plans, mechanic's lien releases, and punch list items. Landlords will usually want an outside date by which the tenant must request the final payment of the allowance, but tenants need to take care that it is not too tight a time frame. Many of these items linger on for weeks or months until they are obtained. Finally, the lease should address what the tenant is allowed to use the tenant improvement allowance for. A landlord prefers (and indeed a landlord's lender may require) that tenant improvement allowances be only used for actual improvements to the building – walls, roofs, plumbing, mechanical systems - and not for tenant's trade fixtures.

DEFAULT. There are many ways in which a tenant can default, but first and foremost is the failure to pay rent when due. As referenced above, "Rent" can be minimum rent, CAM Expenses or other pass-through expense, or any other amount that the tenant owes the landlord under the lease. If the tenant fails to pay, the landlord will want all remedies available at law or in equity. Different states have different ways of dealing with a tenant's monetary default under a lease. In California, for example, if a landlord terminates the lease due to a tenant default, the rent recoverable by a landlord is established by fairly specific methodologies in a statute. Other states may handle it differently or leave it entirely to the parties. Numerous issues arise in negotiating monetary default provisions. Tenants will want to include an obligation of the landlord to mitigate its damages. Tenants will want to limit damages to actual damages, and specifically exclude consequential, special, and/or punitive damages. Landlords will want late fees to apply, and will also want interest on past due amounts to accrue. If a tenant is 10 days late paying its rent, the interest will not be as significant as a 5% late fee, but if the delinquent amounts remain outstanding for months, then interest will be a meaningful amount.

SUMMARY. As mentioned at the outset, in large part a retail lease is a roadmap of who has to write the check and when. Both sides want something; the landlord wants a tenant in the space paying rent, and the tenant wants a location in which to operate. As lawyers, we cannot change the relative bargaining power of our clients. What we can do is provide value to our clients. Nobody "likes" paying their legal bills, but they hire lawyers because they add value to a transaction. No transaction of any type or size is without risk. If he or she is doing his or her job, the lawyer identifies risks and communicates those risks to its client. The client may not like the result, but at least

it was made aware of the risk when it entered into the lease. The other key thing the lawyer can do to add value is to be clear. Ask the questions that are necessary to understand the business point and the client's position on it. Draft as clearly as possible so that there is little room for dispute if an issue arises. As mentioned previously, disputes and litigation take time and are costly, both in terms of money and "human capital." If we can help our clients fully understand all that they are signing up for in a lease, and we can make it clear, we have done a good job and have added value to the transaction.