

Today's Special: Specialty Leasing in the Current Retail Environment

**Jenna Morley
Daoust Vukovich LLP**

Introduction

As the retail landscape continues to evolve, experiential concepts and unconventional uses have gained widespread popularity in Canada. While the fundamentals of commercial leasing law apply equally to all tenants, leases to specialty use tenants pose a unique and interesting set of challenges for both landlords and tenants. The purpose of this paper is to address some of the key issues to consider when drafting and negotiating leases (or licence agreements) for three types of specialty use tenants: pop-ups, entertainment/amusement facilities, and food halls.

Pop-up Tenancies

Pop-up or “flash” retail refers to the trend of opening small-scale, short-term retail stores to showcase local artisans and entrepreneurs. Established and luxury brands also use pop-up stores to test new products or geographic locations, and to engage consumers in new, interesting ways. For landlords, pop-ups present an attractive opportunity to fill vacant space and add profit quickly. From the tenant’s perspective, pop-ups allow retailers to elevate their brand and experiment with new concepts without long-term commitment.

The Document

A central consideration of any pop-up deal is the type of agreement that will govern the parties. In most cases, pop-up deals move quickly and are temporary in nature. For that reason, the landlord’s standard form commercial lease is unlikely to fit the bill. The goal of the parties should be to use a form of agreement that is simple, yet effective.

The two most common types of agreements for pop-ups are the short-term lease and the licence agreement. The fundamental difference between a lease and a licence agreement is that a lease provides a tenant with exclusive and irrevocable possession of the premises, while a licence agreement merely grants the licensee a contractual, non-exclusive right to use the licensor’s property for a specific purpose. While a lease conveys a property interest onto the tenant that is binding on third parties, a licence agreement is a personal, revocable right that does not create an estate in land.

The determination of which type of document best suits the circumstances generally depends on three factors: (1) the length of the term, (2) the complexity of the business arrangement (including the rent structure), and (3) the use of the pop-up space. For relatively short term, uncomplicated deals, the licensor/landlord may prefer a licence agreement, which contains broad termination rights that are exercisable on short notice. This type of flexible arrangement ensures the space remains marketable to attractive long-term tenants and allows the licensor to recapture the space quickly if the pop-up use is found to be undesirable or incompatible with the merchandising mix of the shopping centre. For longer term pop-ups with complex business terms, a simplified form of short term lease might be more suitable.

It is critical to note that nomenclature is not material to the determination of whether an agreement is properly construed as a lease or a licence agreement. The substance of the agreement, rather than the name of the document, will guide a Court's determination of whether the parties agreed to a lease or a licence agreement. If the intent is to create a licence agreement, the parties should ensure that (1) the correct terminology is used in the agreement (licensor and licensee vs. landlord and tenant, and licensed area vs. premises), (2) the licensee is not granted exclusive possession to any portion of the property, and (3) transfer rights of any kind are avoided – the licence should be expressly personal to the licensee.

Rent and Other Charges

Rent for pop-up locations is typically lower than that garnered by traditional retail leases, and is often structured as a gross fee that includes common area expenses, property taxes, and in some cases, utilities. Depending on the length of the term, the gross rent (or licence fee) may be payable as one lump sum on the commencement date, or in monthly instalments at the beginning of each calendar month.

However, pop-up users with little upfront capital may prefer a percentage rent structure, in which the user pays the licensor/landlord a specified percentage of the user's gross sales from the pop-up location. This rent structure is appealing to pop-up users since it correlates directly with the success of the user's business. For the same reason, a percentage rent structure may be less appealing to the licensor/landlord, as an underperforming pop-up user will generate less rent.

One drawback to the percentage rent structure is that unsophisticated pop-up users may not have the means or knowledge to properly record and report gross sales for purposes of calculating percentage rent. As such, licensors/landlords may prefer to adopt a percentage rent structure with only recognized brands that can support adequate record keeping. Alternatively, the licensor/landlord may work with the pop-up user by providing a standard form of sales report and clear instructions for submitting that report.

Transfer

Since pop-up shops typically occupy small areas of retail space for very short periods of time, the licensor/landlord should prohibit the pop-up user from assigning or subletting any part of the space. The governing agreement should clearly state that the agreement is personal to the named pop-up user and is expressly subject to the condition that it not be transferred or assigned, nor will the licensed area/premises be occupied by any other party. This position is generally defensible in a short term pop-up arrangement.

Pop-up users, on the other hand, will require an exit strategy (i.e., the right to assign or sublet) if the business fails, unless the user has flexible termination rights in the governing agreement and little capital invested in the deal. Accordingly, the pop-up user should seek to negotiate certain limited transfer rights that are subject to the prior written consent of the licensor/landlord (not to be unreasonably withheld).

Risk Allocation

The risk allocation provisions of the pop-up lease/licence agreement are arguably the most critical. Pop-up users should be obligated to maintain comprehensive insurance similar to that required under a landlord's standard form lease. Since the rental stream flowing from many pop-up arrangements is often negligible, licensors/landlords are justified in shifting as much risk and liability to the pop-up users as possible by way of the risk allocation provisions, including releases and indemnities.

Default and Termination

Since pop-users are often unsophisticated, entrepreneurial parties, and since speed is key to pop-up deals, licensors/landlords may overlook certain operational issues or failures of the pop-up user, such as the pop-up user's failure to secure relevant permits or to respect existing exclusives at the shopping centre, and rely instead on strong default provisions and peremptory termination rights to be exercised at the discretion of the licensor/landlord. As such, the governing agreement should permit the licensor/landlord to terminate the deal immediately in the event of a default. Further, the licensor/landlord should insist upon a unilateral right to terminate the agreement at any time, with minimal notice, for any reason (or no reason) whatsoever (this unilateral termination right should be placed outside of the default article of the governing agreement to ensure the pop-up user cannot assert a right to obtain equitable relief).

By contrast, pop-up users will oppose wording that allows the licensor/landlord to terminate the agreement for any, or no, reason. Reasonable cure periods will also provide the pop-up user with an opportunity to correct the offending conduct or activity and make adjustments to its business that may lead to greater profit and success.

Entertainment/Amusement Facilities

As commercial landlords face the challenge of filling vacant anchor stores such as Target and Sears, "experiential" entertainment brands, such as Playdium, Punch Bowl Social, and Dave & Buster's, have come to the forefront of the retail industry. Cineplex, which has recently transformed from a movie company to an entertainment company, has announced plans to open between 10-15 The Rec Room entertainment complexes in the coming years, ranging in size from 40,000 to 60,000 square feet. Entertainment/amusement facilities like The Rec Room offer amusement, gaming, technology, live entertainment and dining, all under one roof. Each location devotes approximately half of its area to dining and live entertainment and the other half to amusement games and attractions. As these entertainment-centric uses continue to grow, landlords and tenants must turn their minds to the unique business and legal issues facing the parties.

Construction and Design

More than the average retail tenant, entertainment/amusement facilities require a number of design and construction considerations, including physical requirements, such as ceiling height restrictions, the existence of any columns or other structural obstructions which could

compromise playing space and/or sightlines, and the availability of exclusive rooftop space for satellites, antennae and other transmission equipment. Rooftop access rights are particularly critical for entertainment/amusement tenants, as they rely heavily on uninterrupted satellite transmission to broadcast content and run gaming facilities. Most landlords are amenable to granting such rooftop access rights, provided the tenant complies with laws and installs any screening devices required by the landlord or the municipality.

Considerations regarding noise and vibration attenuation, particularly where the premises are connected to a larger shopping centre, should also be addressed at the design and construction phase. In order to ensure that the operations of neighbouring tenants are not disturbed by the activities in the entertainment/amusement facility, landlords should ensure that the lease expressly addresses standards relating to maximum noise and vibration decibels, as well as the landlord's remedies if the tenant's attenuation strategies are not sufficient or effective.

Operating Hours

Entertainment/amusement facilities tend to operate on a unique daily schedule. While morning hours are quieter for these tenants, most entertainment/amusement facilities stay open long past the standard operating hours of the shopping centre. Where the premises are connected to an enclosed mall, the parties must address access issues, including which mall entrances/exits will remain unlocked for patrons after the shopping centre closes, as well as security issues related to the tenant's extended hours. Landlords should consider whether the tenant will be required to contribute to any of the additional costs and expenses incurred by the landlord as a result of the tenant's unique operating hours, including the cost of after-hours interior and exterior common area lighting, heating/cooling for common areas, and other maintenance services such as snow removal.

Entertainment/amusement facilities, much like movie theatres, have their own security concerns related to safe and secure access to parking facilities by the tenant's employees and invitees. As such, it is not uncommon for the lease to state that the landlord is required to maintain (1) proper illumination of the parking facilities, and (2) security for the shopping centre, for a specified period of time after the tenant closes for business each night. Again, the landlord must consider whether the tenant will be required to foot the bill (or a portion thereof) for the provision of these after-hours services.

Parking

Most entertainment/amusement facilities will require significant parking for extended periods of time. In negotiating the lease, the parties should consider whether any reserved parking will be required, the proximity of the parking to the premises, and whether any charges will be levied for the use of the parking facilities. While tenants are primarily concerned with having adequate (and preferably free) parking available for their customers, landlords have an interest in ensuring that sufficient parking facilities remain available for customers of the balance of the shopping centre. Similarly, given the extended hours that entertainment/amusement tenants operate (as discussed above), the parties will have to come to an agreement regarding the frequency of snow removal and location of snow piling.

Use and Prohibited Uses

a. *Use*

For commercial landlords, narrow, tightly drafted use clauses are crucial to developing and controlling the merchandising plan for the shopping centre. From the tenant's point of view, however, a permitted use clause should be sufficiently broad to allow the tenant to stay current with trends and adapt to changing market conditions. This type of flexibility is particularly critical to entertainment/amusement facilities, since the entertainment industry is in a constant state of evolution. As such, entertainment/amusement tenants may require a broad use clause that includes *the right to operate for any use which may now or in the future be considered normal or incidental as part of an entertainment centre establishment*. Generally, landlords will agree that changes consistent with the evolution of the entertainment industry are permitted, provided that they do not conflict with any existing exclusive uses at the shopping centre.

b. *Prohibited Uses*

Tenants with significant bargaining power often seek to impose a laundry list of prohibited uses on the landlord, which outline certain undesirable or offensive uses that are expressly prohibited in the shopping centre. Standard prohibited uses typically fall into one of three categories: (1) non-retail uses, (2) noxious and offensive uses, and (3) high-intensity parking uses. Many tenants will argue that entertainment-type uses are undesirable because they interfere with the availability of customer parking for the balance of the shopping centre. As such, before entering into a lease with an entertainment/amusement facility, the landlord should carefully review any existing prohibited use clauses at the shopping centre. It is not uncommon for the following uses to be prohibited: bowling alley, video game or amusement arcade, carnival or amusement park, entertainment facility, pool or billiard establishment, auditorium or ballroom, and bingo or similar games of chance. Similarly, when negotiating prohibited use clauses with new tenants, landlords should consider whether any of these historically offensive uses should be softened or eliminated to permit the types of entertainment/amusement facilities that have become commonplace in the retail industry.

Food Halls

The traditional food court features a familiar selection of quick-service restaurants with shared seating. Initially envisioned as a way for mall shoppers to recharge quickly, the food court focuses on convenience and speed.

Today, however, the conscious consumer is demanding healthier, higher-quality fast food. The food hall, a modern reincarnation of the traditional food court, aims to satisfy the consumer's increased desire for diverse food "experiences" by offering a curated selection of eateries, artisan shops and restaurateurs. Inspired by traditional European markets, the food hall features extensive, high-end culinary options in a communal atmosphere.

Food halls offer budding chefs a small-scale opportunity to operate restaurant locations at a fraction of the traditional startup cost. For developers/landlords, a food hall can effectively anchor a large office development, shopping centre, or high-rise residential tower.

Structuring the Food Hall Deal

Food hall deals are typically structured in one of three ways: (1) the owner builds/manages the food hall and licenses/leases units to vendors; (2) the owner builds the food hall and enters into a management agreement with a food hall management company to select vendors and operate the food hall (adapted from traditional hotel deals where one company coordinates the operation of multiple in-house restaurants); or (3) the owner leases the food hall to a tenant operator who is responsible for all phases of design, construction, management and selection of vendors (e.g. Assembly Chef's Hall in the Richmond-Adelaide Centre).

The choice of deal structure will depend on the owner's expertise and desired degree of control over the food hall. Option 1 provides the owner with maximum control over the selection of vendors and day to day operations of the food hall. Under the management agreement structure (option 2), the food hall management company curates the vendors and manages the food hall operations. The management agreement between the owner and the management company often requires the management company to obtain the owner's consent to the proposed food hall vendors and includes clear provisions governing termination of the management agreement in various circumstances (including inadequate performance by the management company).

Under option 3, the owner relinquishes control of the day to day operations of the food hall to its tenant operator, who will design and build out the food hall, contract directly with the curated vendors (by way of a licence or short-term sublease) and manage the operation of the food hall. In this scenario, the tenant operator, rather than the owner, shoulders the bulk of the capital investment.

Term and Co-Tenancy

The success of the food hall is dependent on constant evolution. Vendor turnover is both necessary and beneficial to keep the food hall fresh and to keep patrons interested. For that reason, food hall vendor agreements (whether leases, licence agreements or concession agreements) are typically for short terms ranging from one week to one year.

With short-term food halls (as well as pop-ups and entertainment-type uses) replacing traditional long-term anchor tenants, many commercial landlords are revisiting co-tenancy provisions in commercial leases. Generally, a co-tenancy provision allows a tenant to pay reduced rent or to terminate its lease if certain levels of occupancy in the shopping centre are not maintained. Arguably, the co-tenancy provision takes an outdated perspective on retailing that is modelled on the existence of one or more long-term anchor tenants. In today's changing retail market, many landlords are seeking to eliminate co-tenancy provisions going forward, or to modify their standard co-tenancy provisions to ensure that temporary or non-traditional retail uses will satisfy the co-tenancy requirement.

Exclusive Uses

Restrictive covenants and exclusive use provisions are commonplace in commercial leasing. From the tenant's perspective, a restrictive covenant or exclusive use provision is critical to ensuring the tenant remains competitive in the shopping centre. However, in the food hall context, landlords and tenants alike must understand the nature of the food service industry. While diversity of menu offerings is crucial to the success of the food hall, there is significant potential for overlap of menu items among food hall vendors offering unique and ever-changing concepts. Given the high rate of vendor turnover in food halls, the granting of restrictive covenants and exclusive use provisions may be administratively burdensome for the landlord/food hall management company. If a restrictive covenant or exclusive use provision is granted, commercial landlords should limit the restriction to the *principal* business of the sale of certain protected menu items (such as pita style sandwiches or hamburgers) or to a specific ethnic food style (such as Mexican food). The term "principal" may be defined as a specified percentage of menu items or a specified percentage of gross sales (though restrictions tied to gross sales can be difficult to monitor/track if tenants are not required to deliver monthly gross revenue reports to the landlord).

Conclusion

As the retail industry continues to evolve, so too must landlords and tenants (and their lawyers). When drafting and negotiating leases with specialty use tenants, don't be afraid to take off your legal hat and be pragmatic. Working collaboratively with these creative, entrepreneurial tenants can be a rewarding and lucrative experience for all involved.