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Workshop #8

YOUR EXCITEMENT KNOWS NO BOUNDS — UNTIL IT READS YOUR RADIUS RESTRICTION

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What is a Radius Restriction and Why Would Either Party Want One?

A radius restriction is a provision in a commercial lease that prohibits a tenant from opening a new store within a certain radius of the tenant's premises and is typically found in deals where the tenant is obligated to pay percentage rent or where tenant has a kick-out right (i.e. right to terminate the lease early). In percentage rent deals and deals where the kick-out right is tied to sales, the radius restriction is intended to prevent additional nearby stores from diluting the tenant's sales at its location in the landlord's shopping center (for purposes of these materials, the "Premises"). Radius restrictions are also helpful in non-percentage rent deals to protect against a tenant cannibalizing one location by opening a competing location across the street and thereby limiting the potential of default by the tenant in the subject premises.

Unsurprisingly, tenants are generally not a fan of radius restrictions. While landlords may find this difficult to believe, retailers do not approach their store locations in a random or haphazard fashion. In general, every retail tenant scouts out different sites in order to maximize gross sales through expanding and upgrading their distribution network. While the level of complexity will vary based on the size of the organization, tenants develop strategic property plans every year that proceed through variations of the same general steps: (1) analyze existing properties and evaluate the sales performance of the location against the economic terms of the lease; (2) identify poor performing locations, either because the location generates low gross sales or because the poor economics of the lease creates low net sales; and (3) based on the amount of capital available, identify new locations. These may be "net new" locations or the relocation of a poor performing store, but in either event, tenants will compare the demographics of a given area against the retailer's "ideal customer" and then work to open locations where those two factors happily collide.

Like retail, the real estate market is heavily competitive. Every shopping center is unique in terms of the age of its infrastructure, its amenities, its tenant mix, and even just its décor (and of course, location, location location!). Just as tenants compete for customers to buy their products and services, landlords must compete as well. Landlords are aware of how their shopping center compares to others in their geographic area and radius restrictions are helpful in preventing tenants from jumping ship (or, depending on which side of the table you stand, short-circuit that need to be competitive). After all, a landlord need not be concerned that the new shopping center down the street is offering better rent and/or a better customer shopping experience, such that its current tenants might be enticed away, if they can simply penalize such current tenants to the point where they cannot justify opening a new location.

A competitive market rewards those who improve their product while at the same time negotiate in a fair, even-handed manner. From a tenant's perspective, opening a new location is an expensive, strategic decision and no tenant profits by spending their capital budget in a manner that fails to increase topline sales. Radius clauses

are short-term tools that prevent something that a tenant would never intentionally create, a situation where one location's gross sales are cannibalized by another, while at the same time reducing the need for landlords to be competitive. From the landlord's perspective, radius restrictions provide reasonable protection to ensure that the landlord fairly obtains the benefit of its bargain in the form of percentage rent or continued term when a tenant faces the risk of losing its right to terminate early.

What Goes Into a Well Crafted Radius Restriction Provision?

There are three main concepts that should be addressed in any well drafted radius restriction: (1) the physical boundaries of such radius restriction; (2) to whom the radius restriction applies; and (3) landlord's remedies if the tenant violates the radius restriction. Due consideration should also be given to whether or not the radius restriction is enforceable.

Boundaries

From the landlord's perspective, the goal in establishing the boundaries of a particular radius is to identify an area that is robust enough to provide real protection against a tenant opening a new location that dilutes sales from the Premises. Tenants, on the other hand, want to ensure that the radius does not adversely interfere with their future expansion plans or their ability to close a non-performing or under-performing store and replace it with one that performs well. Whatever radius is decided upon must be reasonably related to the legitimate business interest that the landlord desires to protect. Percentage rent or no, a radius restriction that covers more than a few miles is very likely to be unenforceable.

The boundaries of a radius restriction can be established in a number of different ways and depends on the particular market a property occupies and the legitimate business interest the landlord desires to protect. It is important to both parties that such boundaries are clearly delineated as any ambiguity could lead to future disputes. In suburban markets, a common approach is to say that the tenant will not open another store within X miles from the shopping center with a well drafted provision specifying from what point in the shopping center such X miles runs – e.g. five (5) miles from the outside boundaries of the shopping center or five (5) miles from the lease lines of the Premises. Other alternatives include identifying specific shopping centers or buildings or even specific streets or city blocks.

While landlords will push for an as large as possible radius, tenants need to carefully consider their expansion plans, existing stores and third-party limitations, such as franchisor requirements under a tenant's franchise agreement. At the bare minimum, from the tenant's standpoint, any acceptable radius restriction must carve out existing locations and ideally will carve out locations slated for future expansion.

To Whom the Radius Restriction Applies

It is equally important to clearly identify to whom the radius restriction applies. Since many tenants are single purpose entities, it is critical to include the tenant entity plus its affiliates and owners, otherwise the owners of the single purpose entity could circumvent the radius restriction by creating a new entity. Similarly, the radius restriction should not be limited solely to the same trade name as the tenant is operating in the premises and should, instead, describe the type of business the tenant is operating in the premises.

Tenants, on the other hand, will want to limit the radius restriction to the contracting tenant entity and the exact same business, including trade name, as being operated from the Premises. If that approach is not successful, tenants should carefully define what "affiliates" the radius restriction applies so that the term does not include individuals or entities over which tenant has no real control, such as a franchisor or other franchisees. Tenants should also be sure the description of the restricted business permits the tenant to open similar, non-competing businesses. Consider a gym tenant who also operates wellness centers – a carefully crafted radius restriction would permit both operations.

Remedies:

Because damages are often difficult to prove in the event of a breach of a radius restriction, a well drafted radius restriction will also expressly set forth landlord's remedies if the tenant violates the radius restriction; options include injunctive relief, a fixed increase in minimum rent, deeming the gross receipts from the violating premises to count towards the gross receipts of the premises, default and termination.

When drafting an appropriate remedy, the parties should consider why the radius restriction is important. For instance, if the subject deal requires that the tenant pay percentage rent, then including the gross receipts from the violating premises is critical; that concept is less critical if percentage rent is not part of the deal. Similarly, a fixed increase in minimum rent in such instances might not be relative to the harm to the landlord and is therefore unnecessarily punitive to the tenant. If the radius restriction is related to a tenant kick-out right or right to go dark, then an appropriate remedy might be to negate the kick-out or go-dark right in question. Tenant should ensure that whatever remedy the parties agree upon, that the exercise thereof should be landlord's sole remedy, an approach most landlords will almost surely object to.

Enforceability:

Both parties must also consider whether or not their radius restriction is legally enforceable. Generally speaking, a court will look to see if the clause is clearly drafted and "reasonable". To be considered "reasonable" a radius restriction must:

- (1) Be necessary to protect a legitimate business interest (such as protecting a percentage rental income stream); and
- (2) Not be overly broad in scope, including in location, duration and scope.

[Fab'Rik Boutique, Inc. v. Shops Around Lenox, 2014]

[Pacific Infinity Co., Inc. v. Xi Wan Li, 2013]

SAMPLE RADIUS RESTRICTION PROVISIONS

Landlord Friendly:

In the event that Tenant or any other party, firm or corporation who controls or is controlled by Tenant or Tenant's controlling stockholders, partners or owners, shall own, operate or maintain, in any [restaurant(s) and/or bar(s) of the same or similar nature (meaning similar menu, price point and concept) as that of the restaurant and bar being operated at the Premises], and said other [restaurant] shall be located within a ten (10) block radius of any boundary of the Building, then all of the sales and transactions from any such other store shall be included within the definition of "Gross Sales" for purposes of this Article 5 as though such sales or transactions had been made in, on or from the Premises; and for such purposes Tenant shall be required to submit reports and maintain records with respect to such sales and transactions, and Landlord shall have the right to examine and audit such reports and records, just as though such sales and transactions had been made in, on or from the Premises.

As of the date of this Lease, Tenant shall not directly or indirectly, without the prior written consent of Landlord, operate, manage, franchise, license or have any interest in any other business located within a radius of three (3) miles from the outside boundary of the Shopping Center, which business is engaged in the same or similar use as the use provided for in this Lease; nor, if Tenant is a corporation, shall any officer or director, or any shareholder owning more than ten percent (10%) of the issued and outstanding stock of Tenant, nor any entity affiliated with Tenant in any manner whatsoever, have any such interest without the prior written consent of Landlord; nor, if Tenant is a partnership, shall any partner or any member of the immediate family of any partner nor any entity affiliated with Tenant in any manner whatsoever have any such interest without prior written consent of Landlord; nor if Tenant is a limited liability company, shall any officer or member of Tenant or any member of the immediate family of any officer or member of Tenant nor any entity affiliated with Tenant in any manner whatsoever have any such interest without prior written consent of Landlord. If, during the first five years of the term, Tenant or any such officer, director, shareholder, affiliate, partner, member or family member (collectively, an "Affiliated Person") does operate, manage, franchise, license or have any interest in any such business without the prior written consent of Landlord, Landlord shall have the right, at its option, in addition to all other rights and remedies to which Landlord may avail itself pursuant to this Lease, as liquidated damages and not as a penalty, to require that sales resulting from such business shall be included in the amount of Gross Receipts used to compute Percentage Rent hereunder. After the first five years of the term, if Tenant or any such Affiliated Person does operate, manage or have any interest in any such business without the prior written consent of Landlord, Landlord shall have the right, at its option, in addition to all other rights and remedies to which Landlord may avail itself pursuant to this Lease, as liquidated damages and not as a penalty, to require that sales resulting from such business be included in the amount of Gross Receipts used to compute Percentage Rent hereunder. The prohibitions in this Section 6.03 shall extend to and expire on the expiration date set forth in Section [_____] hereof notwithstanding any earlier termination resulting from Tenant's default hereunder. Landlord and Tenant acknowledge and agree that the amount of liquidated damages set forth in this Section [_____] is a fair and reasonable estimate of damages and that this Lease is a commercial transaction in which both parties were represented by counsel of their respective choosing. Tenant hereby waives any right to claim that the amount of liquidated damages in this Section may constitute a penalty. The payment of such sums shall not relieve Tenant of any of its obligations under this Lease.

Inclusion of Gross Sales:

Landlord and Tenant acknowledge that they expect the Center to draw its customers from a large geographic area and that the success of the Center and income of Landlord therefrom are dependent upon maximum customer traffic within the Center. In addition, Tenant acknowledges that Landlord is relying on the generation of Percentage Rent from Tenant's Gross Sales at the Premises. Therefore, Tenant agrees that if during the Term of this Lease either Tenant or any person, corporation, partnership, limited liability company, or other entity which controls Tenant or is controlled by Tenant or is under common control with Tenant, opens or operates any other [_____] (or other [_____] which (i) uses the same or similar trade name as Tenant uses in the Premises or (ii) utilizes a concept substantially similar to the [_____] within _____ (which Tenant acknowledges is a reasonable area for the purpose of this provision), then in any of such events, during the period of such other [_____] operation, all sales from such other location shall be deemed to be included within the term "Gross Sales" and shall be included when determining the amount of Percentage Rent payable to Landlord under this Lease. In addition, in the event that the foregoing radius restriction shall be breached, Landlord shall also have the right to increase the Minimum Rent payable hereunder by fifty percent (50%) so that Tenant shall pay to Landlord from the date the other [_____] (or other [_____] which uses the same or similar trade name as Tenant uses in the Premises or a concept substantially similar to the [_____] shall open for business one hundred fifty percent (150%) of the

Minimum Rent otherwise due under this Lease. Tenant shall provide statements of Gross Sales with respect to sales from such other restaurant in the manner and at the times set forth in this Lease, and Landlord shall have the same rights with respect to such statements as Landlord has under this Lease.

Gross Sales + Termination:

The parties acknowledge that the realization of the benefits of a percentage rent lease are dependent upon Tenant's maximizing its Gross Sales, and that self-competition is inconsistent with the generation of maximum Gross Sales. The parties further acknowledge that the Minimum Annual Rent was negotiated together with and giving consideration to the Percentage Rent rate and Base and that self-competition by Tenant will deprive Landlord of a bargained-for consideration. Further, the parties acknowledge that the Shopping Center is an interdependent and synergistic environment and that self-competition by Tenant is inconsistent with such environment. Accordingly, Tenant covenants and agrees that during the Term and any extension or renewals thereof Tenant will not, directly or indirectly, engage in any business similar to or in competition with that for which the Leased Premises are let, within a radius of three (3) miles of the Shopping Center, measured from the perimeter of the Shopping Center, without Landlord's prior written consent. The covenant of the preceding sentence shall be inapplicable to any business of Tenant existing as of the date hereof, provided the nature, character, and/or size of such business remains the same and is continuously operated at the same location. If Tenant shall breach the covenant contained in this Section ____, then in addition to the rights and remedies provided in Article ____ of this Lease, Landlord may, at its option, either (i) terminate this Lease upon thirty (30) days' written notice to Tenant, or (ii) enjoin the operation of the violative store of Tenant, or (iii) include all Gross Sales generated by any violative store of Tenant in calculating the Percentage Rent due under this Lease

Specific exclusions:

Except as otherwise provided in this Section, during the Term of this Lease, in the event Lessee or any guarantor of this Lease, or any person, firm, entity or corporation who or which controls (i.e., owns 50% or more of the voting interests) or is controlled by, or is under common control with Lessee or any guarantor of this Lease (an "Affiliate") shall directly or indirectly, either individually or as a partner, officer, director of stockholder or otherwise, own, operate, or become financially interested in any business similar to or in competition with the business of Lessee for the retail sale or lease of _____ of the type commonly sold or leased by Lessee, its sub-lessees or assignees at its retail store in _____ ("competing business") which competing business is conducted within the area described on attached **Exhibit "J"** (the "Restricted Area"), other than (i) _____ (ii) _____ and (iii) catalog/internet mail order business of _____ within the Restricted Area (not originated from the Leased Premises), then, as Lessor's sole remedy for such breach of this Section by Lessee, the gross sales of any such competing business within the Restricted Area shall be included in Lessee's Gross Sales made from the Leased Premises and the Percentage Rent hereunder shall be computed upon the aggregate of Lessee's Gross Sales made from the Leased Premises and the gross sales made from each such competing business then conducted within said Restricted Area.

Lessee shall be obligated to provide Lessor with full and complete gross sales information and reports with respect to any competing business within the Restricted Area in accordance with the requirements of this Lease and Lessee shall be obligated to include the applicable portion of the gross sales of such competing business in with the Gross Sales of the Leased Premises and to pay Percentage Rent thereon in accordance with the terms of this Lease.

Provided however, Lessee shall have the right to build a _____ within the Restricted Area (but not within a radius of fifteen (15) miles of the Shopping Center Project) so long as such store is less than _____ square feet. If a store with more than _____ square feet is built outside the fifteen (15) mile radius but within the Restricted Area, then the Gross Sales of that store will be added to the Gross Sales of the Leased Premises for determining Percentage Rent hereunder.

Provided further, and notwithstanding the foregoing provisions of this Section, neither Lessee nor any Affiliate of Lessee shall, directly or indirectly, own operate or become financially interested in a retail store that is a _____ type store of any size within a radius of fifteen (15) miles of the Leased Premises. Lessor's remedies for Lessee's breach of the prohibition in this paragraph shall not be limited to the remedy described in the first paragraph of this Section and shall include the equitable remedy of injunctive relief.

Kickout:

Provided Tenant's Gross Sales from its business in the Premises for the period from _____ through _____ (the "**Measuring Period**") do not exceed \$ _____ (the "**Threshold**"), Tenant may terminate the Lease by giving Landlord thirty (30) days prior written notice, accompanied by Tenant's statement of Gross Sales, certified as true and by an officer of Tenant. If Tenant exercises its option to terminate the Lease as herein provided, the Lease shall terminate as of the date set forth in said notice and thereafter Landlord and Tenant shall be relieved from any further obligation hereunder, except for (i) any annual adjustments permitted in the Lease, which adjustments shall be for the tax fiscal year and operational year then in effect and shall be prorated to the date of termination and (ii) any indemnification contained in the Lease for events occurring prior to the termination date of the Lease. Notwithstanding the foregoing, if during the Measuring Period Tenant should open or operate any other location similar to and/or using the same trade name as the Premises within _____ miles (which Tenant acknowledges is a reasonable area for the purpose of this provision) (a "**Second Location**"), then in any of such event, Tenant's Gross Sales shall be increased by the amount of gross sales achieved by the Second Location (the "**Aggregate Gross Sales**") and such Aggregate Gross Sales shall be used to determine whether Tenant's Gross Sales exceeded the Threshold during the Measuring Period. If the Aggregate Gross Sales exceeds the Threshold, Tenant's right to terminate pursuant to this Section shall be null and void.

Tenant Friendly:

In the event that Tenant or any other party, firm or corporation who controls or is controlled by Tenant or Tenant's controlling stockholders, partners or owners, shall own, operate or maintain, in a store operating for the Permitted Use and under the Trade Name and said other store shall be located within a ten (10) block radius of any boundary of the Building, then, as Landlord's sole remedy, all of the sales and transactions from any such other store shall be included within the definition of "Gross Sales" for purposes of this Article 5 as though such sales or transactions had been made in, on or from the Premises; and for such purposes Tenant shall be required to submit reports and maintain records with respect to such sales and transactions, and Landlord shall have the right to examine and audit such reports and records, just as though such sales and transactions had been made in, on or from the Premises.

From and after the date of this Lease, Tenant shall not, without the prior written consent of Landlord which consent shall not be unreasonably withheld, conditioned or delayed and which shall not lease space located within a radius of three (3) miles from the outside boundary of the Shopping Center, where the business being operated from such space is the same as the use provided for in this Lease and uses the same trade name as the business being operated in the Premises. If Tenant breaches the foregoing covenant, Landlord shall have the right, at its option and as its sole remedy, as liquidated damages and not as a penalty, to require that sales resulting from such business shall be included in the amount of Gross Receipts used to compute Percentage Rent hereunder.