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12 Key Lease Terms for Restaurants [1]

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Restaurant leases are typically complex and involve hard-fought negotiations. Regardless of whether you are an up-and-coming restaurateur, or an established restaurant group or franchisor, it is imperative that every restaurant tenant carefully review and consider the lease terms and its corresponding business plan before signing the same. Otherwise, the operator might find himself or herself locked into a lease that will force them to prematurely shut the doors and, worse yet, negatively affect pre-existing profitable restaurant units and the brand. In this article, I identify and highlight the importance of 12 key restaurant lease terms that every restaurant tenant should consider before entering into the same.

Premature Termination Rights & Exit Strategy

Delivery of Premises

What happens if an existing tenant fails to timely vacate the premises you intend to lease? Similarly, what happens if landlord fails to timely deliver possession of the premises with its construction substantially complete? Without the right protections, the answer is a tenant might find themselves waiting for a landlord to perform while the restaurant concept loses sales and market position, and is forced to open on an undesired date that causes lackluster sales out of the gate. At a minimum, each restaurant tenant should require landlord to diligently pursue possession (e.g., filing an unlawful detainer action) and extend any rent-free periods to track the actual delivery date. Tenants should also negotiate the right to terminate the lease if landlord’s work is not substantially completed or possession is not delivered by a certain date following lease execution. Reimbursement of out-of-pocket costs (e.g., architect fees, permit costs) incurred in pursuing the business, and the return of security deposit and any prepaid rent should also be negotiated.

Liquor License & Permit Contingencies

A restaurant tenant should always be concerned about their ability to obtain the necessary government permits, approvals, and licenses to build, alter, or otherwise operate their concept from the premises. This is especially true for restaurants planning to serve alcohol or those in need of a conditional use permit. For these reasons, restaurant tenants should negotiate a right to terminate their lease in the event these critical licenses/permits cannot be procured within a contingency period. Key items to negotiate in connection with this right to terminate is: (a) the length of the contingency period (e.g., usually tied to the amount of time it typically takes for such approval to be obtained from the particular authority (i.e., California Department of Alcoholic Beverage Control)); (b) the identity of the permits/licenses at issue (e.g., heath permits, conditional use permit, liquor license); (c) whether landlord will be granted additional time to seek the license/permit on your behalf; and (d) a termination fee (e.g., landlord's brokerage commission).

Gross Sales Termination Right

A gross sales termination right (frequently referred to as a "gross sales kick-out clause") grants a tenant the right to terminate the lease if their annual gross sales at the premises do not exceed a pre-negotiated dollar threshold by or during a particular time or times during the lease term. Contrary to what some might believe, a gross sales kick-out clause can be mutually beneficial. From a tenant's perspective, it offers an exit strategy because the failure to meet the dollar threshold suggests that the particular space is not as profitable as projected. Conversely, a landlord may be persuaded to accept this termination right because the failure to meet this threshold also suggests that landlord will not recoup the rent (by and through percentage rent) that they expected to receive when it underwrote the lease. The gross sales threshold, measuring period, amount of lead-time before termination, and sum of early termination fee will be the key deal points to negotiate in connection with this clause. Typically, the comparison period will not be the first or second year. However, the tenant should seek to negotiate the measuring period to occur earlier in the term so that they have the right to terminate the lease as soon as possible. The threshold amount and termination fee are negotiated on a case-by-case basis. However, the threshold amount is frequently tied to the gross-sales breakpoint, and the termination fee is typically tied to a multiple of base rent and/or landlord's brokers' commission.

Lease Assignment/Sublease

A tenant's right to assign or sublease the premises is critical because it preserves one's exist strategy and facilitates corporate growth. To this end, for starters, tenants need to make sure landlord cannot unreasonably withhold or delay their consent to general assignments and subleases. Tenants will also want to make sure the assignment/sublease language does not include unreasonable conditions to transfer, such as a clause that triggers a substantial increase in rent in the event of a transfer. Tenants should also seek to negotiate permitted assignments/subleases (i.e., transfers that do not require landlord's prior written consent) clauses. Typical permitted transferees include affiliates/subsidiaries under common control as the original tenant, bona-fide franchisees, an entity that survives a consolidation, merger, or reorganization of the tenant or the tenant's parent, and an entity that acquires all or substantially all of the tenant's assets or stock or voting/membership interests. Key items to be negotiated within the permitted transferee language will include: (a) the financial wherewithal of the prospective transferee; (b) the management and operating experience of the prospective transferee; (c) definition of bona-fide franchisee; and (d) the right to share in any transfer premium in the event the transferee agrees to pay any amounts in excess of the rent payable under the lease.

Operating Protective Covenants

Exclusive Use Rights

An exclusive use clause is a covenant by landlord not to allow other occupants in the shopping center to operate a concept that would compete with the business of the tenant. For most restaurants, the need for this covenant is self-evident and will be critical to its future success. However, landlords want to protect their ability to bring in new tenants to accommodate changing demands of consumers and residents. In other words, a landlord does not want to overly restrict themselves in the development and leasing of the balance of the shopping center. The scope of an exclusive use clause will depend on the relative bargaining strengths of the parties and will be among the most hard-fought battles in lease negotiation. If a landlord is amendable, key issues to consider within this covenant include the following: (a) defining the exclusive use; (b) to whom does the prohibition apply (e.g., future occupants); (c) the scope of landlord's obligation to protect the exclusive use right; (d) tenant's remedies in the event of a violation of the exclusive use rights (e.g., termination rights, abatement of rent, damages); and (e) triggering events terminating the exclusive use rights (e.g., default).

Sampling

It is common to overlook the benefit of holding the right to offer samples to prospective customers walking the corridors of a shopping center. It familiarizes people with the concept and attracts them in the event of indecision. It is especially important for impulse purchase concepts. If this holds true for your concept, consider requesting the right to offer free samples of your product within a certain area of the Premises (e.g., 5 feet of the lease line).

Relocation

Restaurant tenants should strongly resist signing leases with a relocation clause because presumably the restaurant chose to lease the space because of its location, and the economic terms of the lease were based on the metrics of that location. Furthermore, the relocation may disrupt the restaurant's business, goodwill, and cause it to lose customers. The new location may also be less accessible and visible. In the event landlord will not agree to remove the relocation provision in its entirety, we suggest negotiating the following items. ***First***, limit landlord's right to relocate your restaurant to a designated area, not more than once during the term, not during the first 12 months of the lease, and not during the months of November and December. ***Second***, require landlord to provide 90 days' notice, at a minimum, of their decision to exercise of this right. ***Third,*** require landlord to pay for the cost of the relocation, including construction and incidental costs incurred by you as a result of the relocation. ***Fourth***, require the new site to be comparable to the original space. It should not vary significant in size. If the space is smaller, rent should decrease. If the space is larger, rent should remain the same. ***Fifth***, insert language that you are not required to close the existing premises for business until a few months after the date landlord delivers possession of the new premises with substantial completion of landlord's work. Rent during this period should also be abated. ***Sixth***, negotiate an unfettered right to terminate the lease in the event such relocation premises is unacceptable. ***Seventh***, negotiate the obligation of landlord to pay for the unamortized balance of the leasehold improvements in the event of termination.

Kiosk Protection

A frequent concern for restaurants in a shopping center is the location of kiosks, carts, food-trucks, and other retail merchandising units ("Kiosks")near the entrance of the restaurant. This concern is fueled by fear that Kiosks will impair customers' access to the restaurant, block visibility of the restaurant, or make the restaurant otherwise appear less appealing. At a minimum, a tenant should require that Kiosks will not be placed in an area that "materially and/or adversely impair access to, or visibility of, the premises." However, a tenant with greater bargaining strength should require that a Kiosk not be permitted within a certain distance of the premises (e.g., 15 feet of the lease line).

Liability & Monetary Protective Clauses

Percentage Rent Exclusions

Many restaurant leases contain a percentage rent clause that requires the tenant to pay landlord a portion of the gross revenues/sales generated from the restaurant as “percentage rent.” In negotiating these clauses, it is imperative to carefully review the definition of “Gross Revenue” or “Gross Sales” to ensure it contains customary exclusions and deductions. Generally speaking, a tenant should seek to exclude from gross sales any items which it makes little or no profit, amounts it does not retain or actually collect, and amounts not from the tenant’s core services/products. Here is a list of common exclusions and deductions we recommend considering when negotiating you restaurant lease:

- The amount of any city, county, state or federal sales, use, gross receipts, or excise taxes on sales or services rendered from the premises where such taxes are added to the selling price, are stated separately, and are paid by tenant directly to the taxing authority.
- The net amount of cash or credit refunds in fact made upon sales from the premises where the merchandise sold or some part of it is returned by the purchaser to and accepted by tenant (but not exceeding in any instance the selling price of the item in question), but excluding any amount paid or payable from what are commonly referred to as trading stamps.
- Exchanges or transfers of merchandise between restaurants of tenant, where such exchanges or transfers are made solely for the convenient operation of tenant’s business and do not have the effect of consummating elsewhere a sale which has in fact been made in, at, upon or from the premises.
- Returns to shippers, distributors, jobbers, and manufacturers.
- Sales of furniture, furnishings, equipment, fixtures or other property not constituting stock in trade and after their substantial use in the conduct of tenant’s business in the premises as permitted by this lease.
- Sums and credits received in the settlement of claims for loss or damage to merchandise.
- Receipts from public telephones, stamp machines, public toilet locks, or vending machines installed solely for the use of tenant’s employees;
- Gift certificates or like vouchers, until such time as they shall have been redeemed.
- The value of any discount given to employees, independent contractors, and employees of any management company of tenant on sales of food, beverages, and merchandise.
- Charges paid directly to credit card issuers.
- Insurance proceeds or other sums or credits received in the settlement of claims for loss, damage or destruction of or to tenant’s merchandise or trade fixtures.
- Sales at a substantial discount or non-cash donations to nonprofit, charitable or religious organizations, provided, however, that the amount of any profit to tenant from such sales shall be included in Gross Sales.
- The amount of any charges imposed directly on sales and collected from customers for the purpose of providing Affordable Health Care in order to comply with the Patient Protection and Affordable Care Act.
- The value of any promotional sales and/or complimentary meals, beverages, and merchandise to vendors, customers, guests, contractors, agents, representatives, invitees, and other like third parties.
- The value of automatic gratuities, tips, service fees, and commissions.
- The value of ATM service fees and commissions.

Common Area Operating Expenses.

Another hot-bed of negotiation in restaurant leases is tenant's obligation to pay for a share of the expenses to operate, manage, and maintain the common areas in shopping centers. Astute tenants will try to minimize the pool of expenses to be allocated and passed through to it by: (a) excluding certain costs from the definition of common area costs or limiting the definition of common area costs; and/or (b) limiting landlord's ability to exclude certain portions of a shopping center. Another method is to request a cap. Typically, the cap prevents the tenant's share of common area expenses from increasing by more than a negotiated percentage over the tenant's share of such costs in the previous year. The cap amount is frequently a fixed percentage (e.g., 3 percent), but it can also be based on a variable number, such as a specific consumer price index. Sophisticated landlords who agree to a cap will want to exclude from the cap items that are not controllable by landlord, including taxes, insurance, and utilities. They also may seek to ensure the cap on operating costs is cumulative, so that any prior unapplied carryovers may be applied in future years. We suggest requiring the cap to be calculated on a non-cumulative basis.

Personal Guaranty Burn-Offs

In today's real estate market, landlords frequently require a personal guaranty by the controlling partners, members, or shareholders of the tenant entity. Frequently implored ways to limit liability under a personal guaranty include negotiating a burn-off clause that automatically terminates the personal guaranty in the event tenant does not commit a default (beyond applicable cure periods) within a certain period of time (e.g., three years following the lease commencement date). Alternatively, guarantors can seek to negotiate a rolling guaranty, pursuant to which they guaranty a certain amount of rent (e.g., two years of rent) for a certain period of time (e.g., first five years) over the lease term or the entire lease term itself. The success of negotiating the limitation of liability will ultimately hinge on the bargaining strength of the parties.

Security Deposit Burn-Offs

Landlords also frequently require large security deposits to protect themselves in the event of a default by tenant. In the event your landlord insists on a significant security deposit, consider negotiating a clause that requires landlord to refund a portion of your security deposit in the event you do not default (beyond applicable cure periods) within a certain period of time (e.g., three years following the lease commencement date).

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