

Real Estate Title Insurance & Construction Law

As One Door Closes, Another Store Opens

Relevant factors in the due diligence process

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With many prominent retailers filing for bankruptcy, there are endless possibilities for those retailers seeking to explore new markets by purchasing leases from bankrupt operators. These opportunities, while often successful, present many challenges. A retailer should conduct an extensive due diligence review to ensure that it can profitably operate in the existing space. While most retailers are familiar with the economic considerations of acquiring an existing lease, assuming a shopping center lease out of bankruptcy involves unique issues. Under Title 11 of the United States Code (the “Bankruptcy Code”), an assignee must accept the lease in its entirety, and often cannot renegotiate any provisions. Also, the assignee is subject to the leases of other tenants and agreements relating to the entire shopping center. In addition, often those heavily negotiated lease provisions intended to be favorable to the original tenant, may ultimately prevent a success-

ful assignment. Although each retailer’s specifications differ, an analysis of many of the following factors will be relevant in the due diligence process.

Use: A retailer must ensure that its particular use is permitted under the lease, and that its exclusive use, if any, is protected. It is important to examine what restrictions are expressly and impliedly imposed on the use of the space. Provisions limiting operation to a specific use, rather than a general, “for any lawful purpose” or “for the sale of clothing” may be problematic if the intended use does not align with the permitted use under the lease. Review of restrictions imposed in reciprocal easement agreements, operating agreements, and similar agreements covering the entire shopping center is critical to the analysis and often overlooked. Finally, exclusive use provisions contained in leases of other tenants in the shopping center may restrict the use in the space at issue. A retailer should not ignore these considerations, even if its use is exactly the same as the debtor tenant from whom it is purchasing the lease.

The following examples illustrate some potential problems. First, another tenant may have an exclusive use provision that restricts the use of both the

debtor tenant and the potential assignee, but provides an exception from the exclusive use by specifically naming the debtor tenant. While the debtor tenant, with the exact same use as the new retailer, would not be prevented from operating, this type of exception would not provide any protection for the assignee. Second, leases and agreements executed subsequent to the lease in question may not have applied retroactively, but may become effective upon the transfer of interest in the lease. These situations highlight some of the reasons that any use restrictions need to be carefully analyzed before purchasing a lease in order to ensure that intended operations will not be hindered.

Zoning: Another use-related issue for a retailer to consider is whether the municipal zoning requirements permit the proposed new use. If the use is a pre-existing, nonconforming use, there may be restrictions on alterations, expansions, renovations and restoration. Other zoning-related inquiries include whether the retailer’s use complies with the building code requirements, whether anticipated renovations will be approved, and whether or not a variance will be required for the new use, parking or anticipated renovations. For instance, changes to a building’s façade or the additional of a “drive-thru” lane may require local approval or

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even a variance. Additionally, a retailer should evaluate any fees imposed for new approvals or permits with a change of ownership or use, as those fees and the approval process may make the acquisition cost-prohibitive.

Cart Corrals: Supermarkets and discount superstores that provide their customers with shopping carts typically require cart corrals, either in the shopping center parking area or on a sidewalk in front of their store. If the debtor tenant did not furnish shopping carts, the lease will not provide for shopping cart storage. Moreover, the lease may prevent such storage by restricting use of sidewalks or parking areas. A landlord may not be inclined to accommodate a new tenant's need for cart storage, as a corral may adversely impact parking ratios, may be prohibited in other leases, or may simply be undesirable in the center.

Parking: In addition to concerns about parking ratios, there are other parking-related issues that may impact a particular site. Certain uses have high or unusual parking demands. For example, restaurants, movie theaters and health club facilities require a greater number of parking spaces for longer periods of time than the average retailer. If another tenant who shares this parking area engages in a high-parking-demand operation, a retailer's parking lot may become overcrowded, which may have an adverse impact on customer traffic. Additionally, some retailers may cater to a clientele with unique parking needs, such as handicap parking or expectant mother parking. A retailer should consider whether anything prohibits the creation of specific parking spaces for these unique needs, such as a provision in another lease prohibiting reserved parking spaces for individual tenants.

Utilities: Many leases contain specifications or provisions related to a tenant's specific utility needs, including: plumbing, HVAC and electricity. Often these specifications are particular to the size and location of the premises. However, a retailer purchasing the lease may have unique needs not contemplated in the original lease. For example, stores containing a frozen or refrigerated foods

section, such as supermarkets and many drug stores, may have heavier burdens on the plumbing and irrigation systems. Similarly, a computer or electronic store may require more HVAC capacity to keep its merchandise cool. To ensure that a retailer's individualized needs can be satisfied, not only should the lease being assumed be carefully reviewed regarding pre-approved specifications, but also the utilities and plumbing systems should be evaluated to ensure they have capacity to support the retailer's needs. Finally, other tenants in the shopping center sharing facility systems with the premises may impose restrictions preventing the shared units from being over-burdened.

Going Dark: A retailer entering an existing location will be unable to open until renovations are complete, signage is erected and the store is fully stocked with merchandise. Temporary closure to complete the necessary fit-out can be problematic if the existing lease prohibits going dark. It is critical to determine whether the go-dark provisions in a lease will provide sufficient time to retrofit the premises in accordance with a specific prototype. This becomes more complicated, costly and time consuming when the fit-out involves the installation of refrigeration equipment, freezers and other unique tenant-specific equipment which may not be typical for a dry goods retailer.

Alterations: Careful examination of the alteration provisions, approval requirements and related limitations is necessary to ensure that the premises can be renovated to make it suitable for the particular tenant's use. Landlord consent, approval rights of other tenants, limitations on the type of structural and nonstructural alterations, staging restrictions and signage limitations are potential impediments to completion of alterations quickly and in the most cost-efficient manner. Another concern is whether subdivision of the premises is permitted. Without this right, retailers who intend to operate in a portion of the premises could be prohibited from subletting the remainder. This is a unique concern because unlike a tenant in direct negotiation with the landlord, an assignee in a bankruptcy proceeding does not have any flexibility to regulate the size of its

premises.

Rent: The rent structure of a lease can significantly impact its value depending on when, during the term, the existing tenant is seeking to assign the lease. In a ground lease, for instance, the tenant may be paying rent substantially below the market rate to compensate it for the cost of constructing its own building, which becomes the property of the landlord upon the expiration of the lease. In this case, a landlord may try to prevent the assignment. It is typically the opposite in a build-to-suit scenario, where the landlord is seeking to recover its construction costs during the initial term. In those cases, during the initial term rent may be above market, but may even decrease in an option period. Other leases provide for payment of percentage rent, based upon a percentage of the tenant's annual sales made in or from the premises. The bankruptcy code may require an assignee to demonstrate that percentage rent will not substantially decline as a result of the proposed assignment. Depending upon the nature of the business, this may be impossible. Percentage rent clauses may also cause the incoming retailer to overpay because the thresholds or percentage rent base is not applicable to the new retailer. In each instance, the impact of rent and percentage rent needs to be fully evaluated in light of the other potential costs associated with assumption, which have been previously noted.

These are only a few of the many due diligence inquiries that a retailer should consider before assuming a lease from a bankrupt debtor. Every retailer has a unique set of needs that will influence what factors it needs to consider. For some, signage may be an issue, while others may have concerns about ingress, egress and loading zones for their delivery trucks. What the bankruptcy process makes clear is that it is essential for any retailer, regardless of its needs, to consider all possible limitations and restrictions, since as an assignee it is subject to not only the requirements of the lease being purchased, but also every restriction imposed upon the shopping center. ■