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Surviving the Retail Shift
Part 5 of a 5 Part Series:
Looking Ahead; Lessons Learned from the Retail Shift

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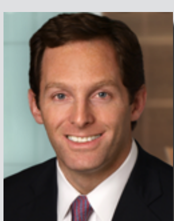

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By Kelly D. Stohs and David P. Vallas

The retail industry has faced significant challenges this year. In 2017, more than 5,000 retail stores closed their doors, many of them portfolio-wide closures by well-known department-store chains who were synonymous with the traditional shopping mall. **Toys R Us recently joined a growing list of more than 35 retailers that filed for bankruptcy in 2017, according to S&P Global Market Intelligence. Even more unsettling, Bankruptcydata.com reports that the Toys R Us bankruptcy is the third largest retail bankruptcy of all time.**

That said, as Mark Twain quipped, “The reports of my death are greatly exaggerated”, so too is the reported retail “apocalypse” and “death” of the shopping center. In fact, **U.S. retailers opened 1,326 more locations in 2017 than they closed, according to IHL Group’s report titled, Debunking the Retail Apocalypse. When restaurants are added to the mix, there were a total of 4,080 new openings in 2017 and another 5,050 openings planned in 2018. Simply put, there are 4,000 more stores and restaurants in 2017 than there were in 2016.** The headlines of the retail apocalypse tend to be focused on a very small number of retailers and segments that are concentrated in shopping malls, and they ignore the growth on the discount end of the retail spectrum. These numbers – and the imbalance toward discount and restaurant openings – reflect a shift in consumer behavior and are compelling an evolution of the traditional shopping center.

Most change does not come without some degree of pain, however, and the current retail shift is no different. Shopping center owners and managers are faced with increased vacancies and fewer traditional options for dark spaces. These trying times are perhaps the best teacher, and the take-away for shopping center owners and managers should be to evaluate your present practices and procedures and identify areas where modifications, as discussed in more detail below, should be made.

- **Act Quickly and Reasonably.** There is often no substitute for speed and reason when it comes to resolving disputes effectively. Shopping centers faced with defaulting tenants have learned the value of acting quickly to collect open account receivables or recover possession of the leased premises. Troubled retail tenants tend to linger as long as possible, squeezing every penny from every last sale before shutting their doors for good, and are often gone before the shopping center owner can recover anything. **Owners and managers of shopping centers who act quickly and use unlawful detainer actions to threaten a defaulting tenant's income stream tend to fare better and often recover more of their open amounts or possession of their leased premises faster.** Haste should not overshadow reason, however. A motivated defaulting tenant can often delay most eviction proceedings for longer than shopping center owners like. There is little doubt that many retailers are struggling. Having realistic expectations about the likelihood and amount of financial recovery will often result in the shopping center owner regaining control of its space faster and (hopefully) replacing the defaulting retailer.

  A landlord's haste should not end when it recovers possession of the leased space though. Many shopping center leases continue to accrue rent even after a retail tenant vacates. A landlord's success in collecting future rent and other damages from the vacated tenant will be affected significantly by the reasonableness of the efforts taken to re-lease the now-vacant space. A dark space by itself is typically motivation enough for many shopping center owners to take steps to re-lease. Where shopping center owners go astray, however, is with documenting these efforts. Leasing representatives should keep detailed notes of communications and meetings with prospective tenants to replace a defaulting tenant and track why certain of these efforts failed. If a shopping center owner cannot prove the re-leasing efforts it undertook, many courts will reduce the owner's recovery accordingly.

- **Control as Much of the Improved Premises as Possible.** When a retail tenant vacates early, shopping centers owners are compelled to market and re-lease the empty space as quickly as possible. One of the many factors in determining how successful a shopping center owner's efforts will be is the condition of the leased premises and whether it is turn-key ready for a replacement tenant. Unfortunately for the shopping center, most tenant improvements are considered trade fixtures – items of personal property attached to the leased premises for the purpose of the tenant's business – and generally belong to the tenant. **Understanding trade fixtures is critical, particularly because many times shopping center owners use tenant allowance to reimburse retail tenants for their purchase of these trade fixtures. The practical effect of tenant allowance payments is the shopping center owner pays for the trade fixtures, which then belong to the retail tenant.** While there is generally a good business reason for these allowance payments, and the amount is typically amortized over some period of time and built into the base rent due under the lease, trouble arises when the tenant defaults and vacates before the end of that amortization period. Under this scenario, the shopping center will often lose the benefit of the rental payments ***and*** the improved leased premises.

  Shopping center owners can protect themselves from this perfect storm by defining in the lease itself what tenant improvements are deemed trade fixtures and whether and under what circumstances a tenant may remove and assert ownership over them. In the absence of a very clear and distinct lease provision defining these rights, courts in most states tend to side with the retail tenant and find that most items of personal property installed in a leased premises for the purpose of the tenant's business belong to and may be removed by the tenant, even after a lease default and no matter how permanently affixed those items are to the leased premises.

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- **Be Creative . . . But Cautious.** As shopping centers evolve and become more focused on value and the shopping experience, owners are changing their tenant mixes to reduce the ratio of apparel retailers and are implementing more mixed-use elements. **They are partnering with technology to embrace omnichannel retail and seizing on opportunities to drive foot traffic, for example, with in-store pick-up of purchases made online.** It is particularly important in this evolution to be mindful not to implicate or violate co-tenancy provisions of leases with existing tenants. **There have been an increasing number of disputes and litigation in which an existing retail tenant argues that the replacement for a vacant tenant with a different or creative permitted use, such as fitness center or office space, is not a "similar tenant" for the purposes of the tenant's co-tenancy lease provision. Likewise, there has been an increase in disputes over the calculation of occupancy percentages applicable to a tenant's pro rata share of operating costs or real estate taxes when a replacement tenant's permitted use of its leased premises is inconsistent with the prior tenant.** Courts have applied co-tenancy provisions and interpreted common terms under these circumstances with varying and often confusing results. Shopping centers owners should take great care when drafting co-tenancy provisions to allow sufficient flexibility to account for when the shopping center industry shifts again.

Looking Forward

Although the spike in retail closures and bankruptcies have fueled the mainstream news media's headlines that have binged on exaggerated stories proclaiming a retail "apocalypse" and the "death" of the traditional shopping mall, retail is not dead, and the shopping center is not going anywhere soon. This is not to suggest that times are not changing. Shopping centers need to change with them, learn from the current retail climate, and be prepared to change again the next time retailers stumble.

Previous Alerts in the **Surviving the Retail Shift** *Series*:

Part I: Manage Expectations & the Legal Process

Part II: A Landlord's Duty to Mitigate its Damages

Part III: Coping with Retail Closures and the Evolution of the Shopping Center: Balancing Creative Uses with Co-Tenancy Provisions

Part IV: Whose Property Is It? What to Do with Personal Property After a Tenant Vacates

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