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Avoiding Heartburn: Restaurant Leases - Parts 1, 2 & 3

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Introduction

Although restaurants often exist in a mixed retail environment or as an adjunct to an office facility, they bring with them a panoply of issues which need special consideration when drafting their leases.

Who is the Tenant?

Restaurant tenants, like most other retail tenants, come in a variety of sizes. The difference with restaurants is that many large restaurant chains exist to franchise their locations so the day-to-day occupant will not be the party the landlord is contracting with. Alternatively, the large restaurant chain may have its operator sign the lease but build in a right to require an assignment of the lease to the chain. At the opposite end of the spectrum is the owner/proprietor who has a vision for his or her own restaurant – a vision which sometimes conflicts with the day to day realities of a retail environment.

At either end of the spectrum, the tenant named on the lease is often not the day to day directing mind of the operation.

One of the interesting linguistic differences between American and Canadian lawyers in this area is that Canadians talk about "covenant", as in, "what is the covenant that the landlord is getting?" Americans are confused by this, since they correctly see the lease as chock full of covenants and are not quite sure which one is being referred to. By "covenant" in this case, we Canadians are really asking what is the net worth of the tenant. At the end of the day, no matter how it is phrased, the key question is, where is the money that is going to pay to construct the restaurant and, once that is done, where is the money that is going to pay the rent? Whether the chain or the operator is on the covenant is a key question for the landlord.

Apocryphally, I have been told by leasing people that it is usually the third restaurant which is successful. They mean the third restaurant in that location. The first may succeed if it is a national chain which has deep enough pockets to sustain months – possibly even a year or two – of losses before its business takes off. For independent restaurateurs, however, their dream is often overtaken by their lack of cash flow before their business starts to run in the black.

Assignment

This means that a sophisticated restaurant tenant (or at least one with a sophisticated lawyer!) will pay extra attention to the assignment provisions of the lease, to make sure that there is an "exit strategy" that will enable the tenant to leave if the cash starts to run out. Landlords are not fond of thinking of lease assignment provisions as an "exit strategy" but, in this case, it is both necessary and meaningful for both parties to focus on what will happen if or when the restaurateur decides to sell the restaurant – regardless of the reasons for doing so. There are certain restaurateurs who have been quite successful in creating a restaurant operation, with their name attached to it, and then selling it once the restaurant experiences its initial success. For these restaurateurs, obtaining flexible assignment provisions is integral to their business strategy and their landlords need to know that this is part and parcel of what they are bargaining for.

What would a restaurant tenant want to focus on in this area? Its starting requirement will be that the landlord has to act reasonably in deciding whether or not to give its consent to an assignment request, so it will want to negotiate to eliminate or reduce any period of time during which the landlord can unreasonably withhold its consent.

Secondly, it will want to assess the landlord's list of what constitutes a reasonable ground for refusing consent. If the landlord requires a tenant with a strong financial covenant, but accepted the original tenant with no covenant, there is an argument that the landlord is trying to better its position on an assignment.

On the other hand, a landlord which is dealing with a restaurateur like the one referred to above, who starts up restaurants and then sells them when they are doing well, may well accept a shell company with no covenant from the original tenant but knows it is bargaining with a sophisticated and experienced restaurateur with a track record of success. In those circumstances, it may be fair for the landlord to require a stronger financial covenant from the assignee than from the original tenant.

What about the requirement many landlords have that the tenant has to have a successful history of operating businesses similar to that being operated in the premises? This would preclude, for instance, an assignee which is composed of one or more parties who have worked in the industry for a number of years, but who have not previously owned their own restaurant. The original tenant may want to seek some flexibility to accommodate this possibility.

A right to change the use may be requested by the tenant in the initial lease negotiations. If the tenant can only assign or sublet for another restaurant use, it will have limited its exit strategy (especially where it seems that no restaurant use will succeed in the location). Many landlords will resist this in their efforts to control tenant mix. This could be one of the main points of contention in the offer negotiations.

Lastly, a landlord may want to protect itself by seeking an indemnity from the principals behind the corporate tenant. The tenant may be prepared to agree to this, especially if the tenant is a shell corporation with no assets, but the indemnifiers will want to understand thoroughly what their obligations are, if and when those obligations will diminish or fall away, and what will happen to that indemnity obligation if the lease is assigned. Landlords will rarely reopen an indemnity at the time of an assignment so the time to clarify all of this is at the time the lease is being negotiated.

Franchising

The other possibility – especially with national chains – is that they may want to keep the lease in their name, but have fairly unlimited rights to sublet the premises to a franchisee which will operate a restaurant under their banner.

For landlords, this is generally understood when initiating the negotiating process with these types of tenants. There are nonetheless precautions that landlords may want to take to ensure that they get what they are bargaining for. Especially for strong national tenants who will not agree to cede much control to the landlord, it is important for the landlords to ensure that they are somehow protected. A requirement that the premises be operated in a first class manner and to the same standards as the tenant applies to the rest of its franchisees is a good starting point.

The landlord would always want to be advised of who is actually occupying the premises, regardless of whether or not it has the right to consent to the franchisee. As well, the landlord would normally want to receive a copy of the franchise agreement and any sublease so that it can be fully conversant with the particulars of the relationship. Realistically, most landlords do not read these but file them away. Nonetheless, they will want to refer to them if a problem arises.

From the franchisor tenant's point of view, the landlord's standard form of lease may require that the tenant give to the landlord any money which the tenant receives in connection with the assignment or subletting of the premises. This is really there to ensure that the tenant cannot collect "key money", or a value attributable to a below market rent, or money which the landlord sees itself as being entitled to, as it made the original investment in the real estate. Regardless of what position any party wishes to take on that issue, in a franchise situation, a franchisor tenant wants to be very sure that its landlord understands that franchise fees belong to the franchisor tenant and not to its landlord.

Use

Restaurants have specific issues that arise from their use, which are not generally at issue in a standard retail tenant negotiation. One of the most fundamental differences between a restaurant and a clothing store is hours of business. Few of us expect to buy clothes much past nine at night, but most of us expect sit-down restaurants to be open still at that time. Similarly, we may shop for clothes at 10:00 in the morning, but we rarely patronize sit down restaurants in shopping centres before lunch time.

Both food court and sit down restaurant tenants will likely want to be able to operate independently of the general operating hours for the shopping centre. Food court tenants may want to close earlier, since there is rarely much traffic in the food court past about 7.30 or 8:00 p.m. At the other end of the food spectrum are the food outlets which specialize in coffee and breakfast items like bagels or muffins. They often want to be open by six or seven in the morning, so that they can capture as much of the morning breakfast traffic as possible. Sit-down restaurants rarely want to open at 9:30 or 10:00 in the morning unless they already have a well-developed breakfast trade. All of these needs will have to be considered in negotiating the lease. In turn, the landlord's need to have the shopping centre open and functioning will also have to be taken into consideration.

The restaurant's proposed use itself will also need to be considered in the context both of existing and prospective uses in the centre. A restaurant tenant will likely not be prepared to be tied to a sample menu appended to the lease for its entire lease term. On the other hand, the landlord will want some certainty that the restaurant will be compatible with, rather than competitive with, existing and prospective users. A use clause, for instance, of "foods derived from various Mediterranean cuisines", although potentially appealing to the demographics the landlord wants to reach, may cross over the themes of several other food sellers in the property including, for example, an Italian restaurant and a Greek restaurant. Even in the absence of any exclusive covenants protecting those uses, a prudent landlord will want to ensure that a new tenant is not cannibalizing the sales of an existing tenant.

Other Tenants' Expectations

As with many retail uses which fall outside of the standard "store" type use, there may be controls in place which prohibit a landlord from proceeding with the deal. A food anchor, for instance, may prohibit a sit down restaurant within 300 feet of its entrance. Many anchor tenants prohibit "arcade" type uses, whether or not they sell food as well, so there needs to be clarity as to whether or not four or five pinball or arcade type machines within a restaurant will cause a problem for the landlord. Similarly, some anchor tenant leases prohibit "nightclubs and discotheques". This wording may have had a clear meaning in the 1970s but is often difficult to interpret in the context of a 21st century shopping centre.

Some in-line retailers may also require that the landlord not lease to food uses on either side of their space. This is uncommon but not unheard of with the more expensive ladies' wear stores, as they do not want their merchandise ruined by careless hands holding ice cream cones, cups of coffee or other food items.

Liquor Licences

Although food court and coffee outlets generally do not need a liquor licence, almost all sit down restaurants will want to serve some sort of alcoholic beverages. Obtaining a liquor licence generally involves a sufficiently complex process that the time between signing the lease and opening the business may be longer than that for most retail uses partly because of the delays involved in obtaining the licence. For landlords, there should be a clear understanding that the tenant will apply for a liquor licence as soon as possible and pursue its application diligently to completion. Although some tenants will "pre-open" while waiting for their licence, for a roadhouse type of tenant, for instance, opening makes little sense without a liquor licence. Although it is self-evident, the use clause should provide that the tenant will only sell liquor if it is properly licensed to do so.

Patios

Here in Canada, where winter can seem endless, patios are treasured additions to restaurants, as the first sunny day of spring will usually find the patios packed full – even if everyone has to wear a sweater!

There are certain complexities to adding patio space into the tenant's use which need to be considered up front. Is the tenant to pay rent on the patio space? Often, a landlord will not want to charge rent because the patio is an exclusive-use common area for five months of the year but for the other seven months of the year, the landlord wants it to revert to common area so that there is no shortfall for that period. A landlord will, however, expect to see the sales from the patio included in the tenant's Gross Revenue for Percentage Rent purposes.

What other issues will a landlord want to focus on? A landlord will likely want the right to approve of the tenant's patio fixtures, to ensure that the tenant is not buying second-rate, on-sale backyard furniture and lowering the appearance of the centre. The tenant will need assurances that there will be direct access from its space to the patio and a clear understanding of who is paying for the doorway to be cut, if necessary.

The tenant will want to ensure that there are proper barricades around the patio space to ensure that it is fluid with the restaurant space and people are not just walking through it on the way to their destination. In turn, a landlord will want to have the usual aesthetic controls over the quality and appearance of those barricades. The landlord will want to ensure, as well, that when the snow flies, those barricades are removed and the patio furniture is stored elsewhere, so that a special summer place does not accidentally become a winter hazard.

Noise and Nuisance Issues

Security is one of the larger issues a landlord will grapple with, both for tenants with patios and for in-line and pad tenants which are open past shopping centre hours. No landlord wants to find out that its roadhouse tenant's patrons got a bit rowdy on Friday night and so the Saturday morning shoppers arrived to a parking lot littered with beer bottles.

A tenant which may attract some rowdy patrons will likely find its landlord insisting that the tenant be responsible for providing adequate security to its premises. A prudent landlord will want to retain the right to put its own security in place at the tenant's cost if it does not approve of how the tenant is handling security issues.

On the nuisance side, landlords of enclosed malls need to be particularly sensitive to noise transfer issues. The construction of the property may make it especially sensitive to this type of issue. I once assisted a landlord dealing with a noise issue which was considerably aggravated by the fact that the original building construction had been concrete slab on steel pan – a type of floor construction which tends to transfer sound through it and which can even intensify certain sound ranges – in this case, the bass line from a dance facility.

There is, in fact, a case from Peterborough relating to a 25 year lease signed in the late 1950s. In this case, the landlord leased ground floor space to a restaurant with banquet facilities based on a brochure which showed the restaurant space as part of a single storey plaza building. Subsequently, the landlord constructed a second storey over the restaurant space and one other tenant's space and leased that second storey space to a bowling alley.

According to the evidence, when bowling was going on, the restaurant's chandeliers shook, the sound of the machines retrieving the bowling balls was clearly audible and patrons of the restaurant could even identify when bowling pins were struck down. Problematically for the restaurant, the bowling alley's prime hours of operation were also the restaurants.

In this case, the Court found in the restaurant's favour and assessed damages for lost profits. This is an interesting example, in that it is often the restaurant which has the potential to annoy other tenants; it is not usually the other way around. Regardless, the point is clear that problems may arise when one tenant's business causes noise at a level which significantly interferes with another tenant's business – an issue to watch out for with certain types of restaurants and, as is transpires, second storey bowling alleys!

Odours and Garbage

As another aspect of any restaurant use, a landlord should expect to spend more time focusing on odours and garbage than might be spent with another type of retail tenant. Cooking food creates smells. Mostly, the smells are pleasant. When the food becomes garbage, the smells can become pretty unpleasant – especially in the summer. Who picks up the garbage, how the garbage is stored, whether the garbage will be refrigerated or unrefrigerated and where it is stored – in a communal facility created by the landlord or within the tenant's premises – these are all important questions that need proper consideration before the deal is signed to avoid disputes and costly fixes at a later date. Preventing and/or controlling vermin will also need to be addressed.

As well, although a tenant may believe that its odours of cooking garlic will entice folks to come and eat at their restaurant, the clothing store next door may have some very different views about trying to sell clothes which are permeated with that garlic smell! Landlords need to consider where the restaurant will be placed, how it will be cooking and what precautions it should require from the restaurant tenant to ensure that other tenants are not disturbed by the restaurant's odours.

Construction Issues

This leads to a larger bundle of issues which are specific to restaurants. Will the tenant be deep frying? If so, is there adequate venting? If not, can it be retrofitted and, if so, who is going to pay for it? This is often a costly retrofit which involves cutting the roof so clear attention needs to be paid to it when negotiating the deal.

Even if the tenant is not deep frying, not all municipalities permit tenants to cook without venting even if the tenant is just cooking with convection ovens. Other municipalities will only require an ecologizer unit in certain circumstances. The time to ask these questions is before the lease is signed as the cost differentials are considerable.

Does the space have a gas line? If it was previously used for cooking facilities, it probably will. If it was a shoe store, it probably will not. Again, consideration needs to be given to how much this retrofit will cost and who is going to pay for it.

Along related lines, there should be a requirement in the lease for a regular schedule of grease trap maintenance to reduce the risk of sewage back ups caused by restaurant tenants dumping their grease down the sinks.

Similarly, there needs to be a clear understanding of who is going to clean the venting system and how often, to reduce the risk of fires.

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Parking, Valet Parking and Drive Throughs

One last issue which is fairly constant with most food type users is that their customers will place different demands on the parking lots than the customers of other types of retail uses. If the average shopper in a shopping centre spends 45 minutes there, this time may more than double if that shopper

stops to eat at a sit down restaurant. Although the gross dollars spent in the shopping centre will inevitably increase and that may justify the impact on parking in the landlord's mind, other retailers – especially destination retailers whose customers want parking close to their entrances – may protest the amount of time that individual parking spaces are tied up by restaurant patrons.

High end restaurants often offer valet parking, which is one of many reasons why they rarely locate in shopping centres, no matter how high end the centre is. Valet parking drop off and pick up usually happens in fire routes, so clear expectations need to be articulated to avoid conflict between the landlord and the tenant. Dedicated valet parking spaces – which may be acceptable for the generic use of all patrons at the shopping centre – will be resented by the other tenants if they are dedicated solely to the use of one restaurant tenant, since all tenants' common area dollars are paying for the maintenance of those valet parking spaces.

Valet parkers usually require some kind of kiosk on the sidewalk; both to store the car keys and to keep the elements somewhat at bay on bad weather days. Again, not all other tenants are going to relish this kind of exclusive licence use of the common areas that all tenants are paying for.

The last parking and car-related issue is the creation of a dedicated drive through lane. We are starting to see, in Canada, the creation of drive throughs for pharmacies, in addition to food outlets. We also have an increasing number of bank ATM drive throughs.

One obvious issue in creating these is to ensure that cars exiting the drive through lanes can do so safely, without causing back ups. On the other side of the coin, there has to be a safe place for the cars using the drive through to queue up so that they do not create a traffic hazard for other drivers or an obstruction preventing other shoppers from entering or leaving their parking spaces.

The location of the drive through lane also has to make sense within the existing rights in the shopping centre. There is no point in agreeing in the middle of the winter to provide the tenant with a drive through lane, only to discover when spring arrives that a food store's garden centre will effectively block all access to the drive through lane. Shopping centres are complex entities which sometimes have almost encyclopedic layers of rights affecting them. Checking and cross checking are the obvious order of the day here.

Final Thoughts

Most of what restaurant tenants do is sufficiently similar to what other retail users do that they can be processed within the same context and can sign the same lease form. In approaching the preparation and negotiation of that lease form, whether you are the landlord or the tenant, there will always be some issues which will require some extra thinking – lest you too get a case of heartburn from your restaurant lease!

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