The Fab Five: Outlet clauses to live by

By Lori Kilberg and Benno Rothschild

OUTLET CENTERS are proliferating, and new players seeking a foothold in this thriving sector should be aware of certain unique features of outlet leases. Although many lease provisions will look familiar to real-estate veterans, there are certain unusual twists and turns that both owners and tenants must navigate to create a successful outlet center. We've outlined five lease clauses that outlet owners and retailers should pay particularly close attention to.

No. 1: Use Provisions. The primary purpose of outlet centers – which sets them apart from other types of retail – is to provide consumers with a "value shopping" experience. Therefore, the use clause in an outlet lease should require that the merchandise available at the store be sold at a substantial discount from the price of the same merchandise at the tenant's full-price stores.

However, retailers have begun to create specific merchandising strategies for their outlet stores, often by manufacturing products exclusively for outlet sale, so comparative pricing on the same goods might not be possible. In that case, "discounted," "off-price," "made for outlet" or similar descriptors will work.

To create the outlet experience, and to avoid dilution of the brands, many outlet-use clauses prohibit retailers from selling brands other than their own. Furthermore, to protect co-tenancies (see No. 4), landlords should specify that the premises can be used for "no other purpose" than the specific use described in the provision.

No. 2: Operating Covenants. Continuous-operation covenants (which ensure that tenants won't go dark unexpectedly) are crucial to the viability of outlet centers. In many big-box and other open-air centers, continuous-operating provisions in the leases of national tenants have become the exception, rather than the rule.

In outlet centers, this trend is reversed. The lack of large anchor tenants, the emphasis on percentage rent as part of the overall economic deal structure, and the acknowledged interdependence among multiple national retailers – many of whom are tied together in an intricate dance of co-tenancies *(see No. 4)* – have made continuous-operating covenants far more prevalent in outlet leases than in other types of shopping centers leases.

No. 3: Radius Restrictions. To be successful, outlet centers must draw customers from a broad geographical area. Radius restrictions, which say a tenant may not operate another store within a certain distance from the outlet center, protect the center against competition in its own back yard.

In other types of shopping centers, radius restrictions are often drawn to cover a narrow trade area of only a few miles in diameter. Outlet centers, however, cover a much larger potential trade area, and sometimes radius restrictions are drafted to cover an area extending out to 60 miles away from the center.

For landlords, crafting a restriction that is narrow enough to defend as a reasonable restriction without being an impermissible restraint on trade is essential. For tenants, insisting on carve-outs for existing outlet and full-price stores and eliminating broad references to affiliates is critical in avoiding future conflicts.

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No. 4: Co-Tenancy Provisions. Outlet centers in many ways mirror the lifestyle centers of the last two decades. Rather than hinging on large boxes or department stores (with the exception of a Saks Fifth Avenue Off 5th, a Neiman's Last Call or a Nordstrom's Rack), these centers rely on a collection of well-branded, high-recognition stores. Tenant mix is extremely important and drives traffic to the outlet center.

Therefore, many outlet retailers will require an occupancy co-tenancy, both as a condition to opening and as an ongoing condition throughout the lease term. This clause is usually drafted in terms of a percentage of the center's GLA that must be open and occupied. Some specialty retailers also will require that a certain number of named "inducement" tenants be open and operating.

Landlords must be careful to leave some flexibility, as it is inevitable that the tenant mix will change over the term of a 10-year lease. This flexibility can be achieved in two ways: a) by providing that fewer than all named tenants be required to remain open (five of eight, for example), and b) by defining the criteria for replacing named tenants that have ceased operating.

Co-tenancy provisions often drive landlords to require continuous-operating covenants from the tenants *(see No. 2)*.

No. 5: Early Termination Rights (gross-sales kickouts). Outlet owners are interested in maximizing the stability of their centers by asking for long-term (10-year) leases from their tenants. To balance the risk of a long-term commitment, many outlet-center retailers are protecting themselves against the possibility of decreased sales over a long-term lease period by requiring early termination options tied to a minimum gross-sales threshold.

The lease may provide for a "measuring period" of 12 consecutive months. If the tenant hasn't achieved a certain amount of gross sales (measured on a psf basis), the tenant will have the option to terminate the lease. The measuring period should occur after the retailer has had a few years to build up sales. For example, if a tenant doesn't achieve a certain amount of gross sales psf during the fifth year of the lease, the tenant may terminate the lease by giving notice to the landlord and providing a copy of the gross sales report within 30 days after the end of the fifth year.

Tenants must be required to be continuously open and operating in order to take advantage of this option. If a tenant in default violates the radius restriction or closes the store during this period, the early termination right should be invalidated. V