How to Construct and Negotiate a Restaurant Lease

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How to Construct and Negotiate a Restaurant Lease

*By **Jonathan M. Grosser***

Royer Cooper Cohen Braunfeld LLC

PREFACE - It all starts with the letter of intent

When should a client reach out to an attorney for assistance with their lease? After they've signed a non-binding letter of intent? NO! At that point, it's already too late. Despite the fact that the letter of intent expressly provides that it is non-binding and merely reflects the general terms upon which the parties intend to negotiate a formal lease, it does set the anchor, and once set, an anchor is hard to move! The landlord will expect the tenant to honor the letter of intent. Should the tenant attempt to change any terms of the letter of intent after it has been signed, such a move may engender bad will between the parties and start the relationship - one that will most assuredly require good will, understanding, and compromise between the parties in the future - on bad footing.

Many of the most important terms of the lease will be included in the letter of intent. If a client fails to include these important terms, they may be handicapping themselves right out of the gate. Before the letter of intent is signed is the time the tenant has the most leverage, so if there is something the tenant clearly needs or wants, the time to ask is while negotiating the letter of intent.

Strong practitioners will not hesitate to mark-up a letter of intent. As long as his or her changes are thoughtful, well done, and reflective of market conditions, a "quality" landlord will not take offense. If the landlord is offended by the tenant's attempts to obtain a strong, but fair, deal, then that alone may be a red flag; maybe that particular landlord is not the party with whom to partner.

Before signing the letter of intent, a client should always seek the counsel of an attorney who regularly reviews restaurant leases. The right counsel will enhance the tenant's chances of success and may stave-off significant wasted time, expense, and mental anguish. The legal expense incurred will pale in comparison to the foregoing.

Success is where preparation and opportunity meet.

- Bobby Unser

1. WHAT MAKES A RESTAURANT LEASE A RESTAURANT LEASE?

Restaurant leases typically come in two forms – (1) a management agreement in disguise (which is typical of a hotel restaurant lease or a lease for a restaurant in a casino, stadium or other entertainment complex) and (2) a traditional retail lease. Hereinafter, I will refer to the former as a "Hotel Restaurant Lease" and to the latter as a "Retail Restaurant Lease". While these lease types are very similar in many ways, there are some major distinctions between the two.

The distinctions between a Hotel Restaurant Lease and a Retail Restaurant Lease primarily regard (a) the party responsible for funding operations and (b) how profits are divided between the parties. Under the typical Hotel Restaurant Lease, the landlord is primarily responsible for funding operations, while the tenant bears the lion's share of such expenses under the traditional Retail Restaurant Lease. Due to this distinction, remuneration payable to and by the respective parties under each type of lease is significantly different. Said simply, the benefits and burdens under the Hotel Restaurant Lease are shared nearly equally by the parties whereas the benefits and burdens associated with the

traditional Retail Restaurant Lease inure primarily to the tenant.

Appreciating these distinctions will inform other more subtle differences between the two lease types and enable the practitioner to more successfully construct and draft each.

2. RESTAURANT- SPECIFIC LEASE PROVISIONS

A. Restaurant-Specific Fees Payable to the Operator (under a Hotel Restaurant Lease)

(i) *Pre-Opening Activities Fee*

a. The Pre-Opening Activities Fee is a fee paid to the tenant in consideration of the Pre-Opening Activities.

b. The Pre-Opening Activities Fee is typically a fixed amount that approximates the sum of (i) the cost to the tenant of conducting the Pre-Opening Activities and (ii) a reasonable amount on account of profit (e.g., 8% - 10%).

c. Typical Pre-Opening Activities include:

.1 Development of a Concept

.2 Establishment of Budgets (Construction, Operations, Marketing, Etc.)

.3 Hiring and Training of Staff

.4 Creating a Menu

.5 Creating a Marketing Plan

(ii) *Management Fee*

a. The Management Fee is a fee paid to the tenant in consideration of operating and managing the restaurant. The Management Fee is the primary source of income to the tenant.

b. The Management Fee is typically a percentage of gross sales.

c. The Management Fee is paid monthly in arears.

d. The Management Fee is sometimes comprised of a "base" Management Fee ("Base Management Fee") and an "incentive" Management Fee ("Incentive Management Fee").

.1 A typical Base Management Fee is between 2% - 5% of gross sales.

.2 An Incentive Management Fee may equal as much as 50% of any net profits.

B. Restaurant-Specific Rent Payable to the Owner (under a Retail Restaurant Lease)

(i) *Fixed Rent*

a. Fixed rent is a fixed amount payable by the tenant to the landlord monthly in advance.

b. The amount of Fixed Rent is market determinative.

(ii) *Additional Rent*

a. Additional Rent payable by the Tenant equals a proportionate amount (based on the rentable area of the demised premises compared to the rentable area of the building or complex in which the demised premises are situated) of the landlord's cost of real estate taxes, insurance costs and other expenses of operating the building or complex in which the demised premises are situated.

b. Additional Rent is typically paid monthly in advance based on an estimate and is subject to a year-end true-up.

c. Tenants typically enjoy the right to audit the Landlord's books and records of Additional Rent.

(iii) *Percentage Rent*

Percentage Rent is often payable in connection with both the Retail Restaurant Lease and the Hotel Restaurant Lease.

a. A percentage of gross sales paid by the tenant to the landlord (e.g., 5% - 10% of gross sales).

b. Percentage Rent is paid monthly in arrears.

(iv) *Operating Profit Rent*

Operating Profit Rent is, essentially, another percentage rental payable to the landlord out of any net profit (rather than gross sales).

a. Operating Profit Rent is a pre-determined percentage of net profits paid by the tenant to the landlord (e.g., 50% of net operating profits). Operating Profit Rent is the landlord's equivalent of the Incentive Management Fee payable to the tenant.

b. Operating Profit Rent is paid monthly in arrears.

C. Priority of Payments

As touched on above, the payment of fees and rents typically follow a certain order. This order reflects the parties' relative investment in and risk associated with the venture.

(i) Payments to the landlord and the tenant are typically paid in the following order:

a. First, Base Rent (to the landlord)

b. Second, Additional Rent (to the landlord)

c. Third, Base Management Fee (to the tenant)

d. Fourth, Percentage Rent (to the landlord)

e. Fifth, Operating Profit Rent (to the landlord)

f. Sixth, Incentive Management Fee (to the tenant)

(ii) Percentage Rent, Operating Profit Rent and the Incentive Management Fee which are unpaid due to a lack of net profit typically carry forward and are paid if and when sufficient net profit exists.

(iii) Accrued but unpaid loans, capital calls, and replacement reserves, if any, are typically returned to the landlord prior to the payment of any Incentive Management Fee to the tenant, and sometimes prior to the Base Management Fee.

D. Tenant's Books and Records

(i) *Account Statements*

Because payments to the landlord are largely predicated on the tenant's gross sales or net profits, it is important that the landlord have access to the tenant's books and records. To ease the landlord's administrative burden, tenants are typically obligated to provide landlords with certain statements reflecting gross sales, expenses of operation, and net profit, if any. These statements include the following:

a. Monthly Statement

An unaudited written statement signed by an officer of the tenant and delivered to the landlord showing the gross sales earned by the tenant and the expenses incurred by the tenant during the prior month as well as the tenant's determination of (.1) the Percentage Rent and Gross Operating Profit Rent payable to the landlord, if any, and (.2) the Base Management Fee and the Incentive Management Fee payable to the tenant, if any.

b. Quarterly Statement

Like the Monthly Statement, the Quarterly Statement includes the tenant's determination of (.1) Percentage Rent and Gross Operating Profit Rent payable to the landlord, if any, and (.2) the Base Management Fee and Incentive Management Fee payable to the tenant, if any, and is certified by an officer of the tenant. However, unlike the Monthly Statement, the Quarterly Statement also includes a reconciliation of all previously accrued and unpaid rents and fees for that fiscal quarter.

c. Annual Statement

The Annual Statement contains all of the same elements as the Quarterly Statement, including an annual true-up of all rents and fees; however, the Annual Statement is often required to be certified by a certified public accountant, and the Annual Statement remains subject to approval by the landlord.

(ii) *Point of Sale System(s)*

Where the restaurant is situated in a hotel, stadium or other entertainment complex, it is not uncommon that the restaurant utilize the larger venue's point of sale system. Where this is the case, the landlord has ready access to the tenant's books and records. This diminishes or negates the need for Monthly, Quarterly and Annual Statements.

(iii) *Audit Rights*

Where the parties do not share a point of sale system, it is important that the landlord have the ability to review and audit the tenant's books and records in order to verify that the Monthly, Quarterly and Annual Statements accurately reflect the sales, expenses, rents and fees disclosed on such statements. Where an audit discloses an error, a true-up is in order. Where an audit discloses a material understatement of the rent payable to the landlord, the cost of the audit should be borne by the tenant. Repeatedly submitting inaccurate statements may constitute a default of the lease.

Where the tenant has a bone fide objection to the auditor's conclusion, the matter may be resolved by arbitration.

To ensure the landlord's right to audit the tenant's books and records, especially with regard to the final year of the lease term, the tenant should be obligated to maintain such books and records for a period of at least one (1) year following the end of the lease.

E. Standards of Conduct

Especially where the restaurant is located in a hotel or other venue, it is important that the operator be mandated to comply with certain standards of conduct in order that the restaurant do what it is intended to do - enhance the operation of such other venue.

(i) *Hotel Standards*

Hotel Standards are standards that apply with respect to the maintenance and operation of a hotel. Hotel Standards are often uniformly applied to all hotels of a given brand or unified ownership. Hotel Standards are independent of Franchise Standards, which are standards of conduct established by a franchisor. Hotel Standards often exist in the absence of Franchise Standards. Independent hotels, for example, will adopt Hotel Standards rather than Franchise Standards.

(ii) *Franchise Standards*

As stated above, Franchise Standards are standards of conduct established by a brand or company which are applicable to the operation of a franchised hotel. Franchise Standards apply to and are binding upon all facilities within a hotel, including restaurants. Franchise Standards may dictate the décor, hours of operation, menu, and other aspects of the operation of any restaurant situated within a franchised hotel. Franchise Standards are typically outlined in the franchise agreement and an

accompanying manual. Franchise Standards are generally not negotiable. Franchise Standards tend to change over time, and all facilities within a franchised hotel are obligated to comply with all such changes, whatever they may be. Therefore, when reviewing a proposed restaurant lease, it is also important that the tenant review and appreciate all Franchise Standards to which it will be bound.

F. Restaurant Operating Covenants

(i) *Covenant of Continuous Operations/Required Hours of Operation*

Restaurant leases typically require that the tenant operate during certain prescribed days and hours throughout lease term. Such prescribed days and hours are intended to drive traffic to the property and maximize gross sales. The purpose and function of the restaurant, as well as the type and amount of rent payable under the lease, will dictate the required hours of operation. For example, where a restaurant is responsible for providing room service, in addition to ordinary meal times, the kitchen of the restaurant will be required to be open in the early morning, for breakfast, and late at night, for snacks and the like.

Where the tenant is responsible for maximizing net revenue, requiring that the tenant operate during breakfast or lunch, for example, may be counter-productive, depending on the type of restaurant and when such restaurant is most often frequented.

Intimate knowledge of the restaurant's history, clientele, offerings and other aspects of operation will help to inform what hours of operation should be mandated.

(ii) *Affirmative Covenants*

Typical Affirmative Covenants include, without limitation, the following:

a. That the tenant prevent unreasonable odors, fumes, vapors or gases that relate to or are connected with the permitted use from being experienced outside of the demised premises.

b. That the tenant keep the demised premises (including the exterior and interior portions of all windows, doors and all other glass of the restaurant) in a clean, neat and orderly condition, free from vermin and other pests.

c. That the tenant cause all garbage to be removed from the demised premises and hauled from the property on a daily basis.

d. That the tenant install and maintain suitable grease traps, fire suppression systems and exhaust systems.

e. That the tenant refinish, renew and/or replace the fixtures, furnishings, decorations and equipment from time to time.

f. That the tenant operate the demised premises at all times in accordance with the lease and all applicable laws and other municipal requirements.

(iii) *Negative Covenants*

Ordinary Negative Covenants include, without limitation, the following:

a. That the tenant not cause or permit music to be played or broadcast anywhere where such music is audible outside the demised premises.

b. That the tenant not use or occupy any portion of the property outside of the demised premises (e.g., sidewalks, building common areas, etc.) without the express permission of the landlord.

c. That the tenant not use or occupy any portion of the demised premises in any manner or for any purpose which would violate the terms of the lease and/or the rules and regulations established by the landlord from time to time.

d. That the tenant not mortgage, pledge, grant a security interest in or otherwise encumber or

cause a lien to be placed upon all or any part of the demised premises without the consent of the landlord.

e. That the tenant not use or permit the demised premises to be used for any purposes that do not comply with the operating standards applicable thereto.

f. That the tenant not use or operate the demised premises in any matter that would violate the reasonable requirements of any insurance company insuring the building in which the demised premises are situated.

g. That the tenant not use or operate the demised premises in any manner that would adversely impair the reputation of the landlord or the building in which the demised premises are situated.

h. That the tenant not permit unreasonable odors, fumes, vapors or gases that relate to or are connected with the permitted use from being experienced outside of the demised premises.

i. That the tenant not create or permit a material nuisance or substantial interference with the use and quiet enjoyment of other building tenants or adjacent tenants or property owners.

j. That the tenant will not use the demised premises for any prohibited uses, including any exclusive uses granted to any other tenants of the property.

(iv) *Liquor License Covenants*

Where the restaurant serves alcoholic beverages as part of its offerings, covenants specific to the sale of such alcoholic beverages as well as the liquor license itself must be included in the lease. Covenants of this sort include, without limitation, the following:

a. That the tenant maintain the liquor license in full force and effect throughout the lease term.

b. That the tenant not do anything that may cause the liquor license to be forfeited, suspended or imperiled.

c. That the tenant operate the demised premises at all times in accordance with all requirements of the licensing authorities.

G. <u>Credit Purchases; Room Charges; Discounts; Special Dining Privileges; Venue Restrictions and Special Events</u>

Where the restaurant is in service of a hotel, services, such as in-room dining and other dining privileges, will be required of the restaurant. These additional requirements must be included in the lease in a way that makes clear the parties' respective obligations and duties in this regard.

(i) *Credit Card Purchases and Room Charges*

A well-crafted lease of the sort described above will specifically provide that the tenant must:

a. Accept all credit cards accepted at the hotel for the purchase of food, beverages and gratuities.

b. Allow patrons of the restaurant who are also guests of the hotel to charge their room accounts for meals, beverages and merchandise purchases made in and from the demised premises. In this regard, it will be beneficial if the restaurant shares a point of sale system with the hotel (or at least one that is compatible with and fully integrated into the hotel's point of sale system).

(ii) *Discounts*

Discount policies and preferred reservations at the demised premises for hotel guests are often addressed in the lease as well. The nature and extent of these policies will tend to vary greatly depending on the characteristics of the hotel and the restaurant.

(iii) *Special Dining Privileges*

Like discounts, special dining privileges can vary greatly from place to place. Special dining

privileges typically include reserving an agreed-upon number of tables for hotel guests during preferred dining hours.

(iv) *Venue Restrictions and Special Events*

Sometimes a lease of the type described above will grant the owner or manager of the hotel the exclusive use of the demised premises on certain pre-determined days during certain pre-determined hours, such as a holiday party for the hotel's staff. The restaurant operator may be obligated to provide services which are not typical, such as a price-fix menu or special holiday décor. Because special events do not tend to generate the typical amount of revenue and tend to limit access to the restaurant by its ordinary clientele, the restaurant operator will want to limit these events to the greatest degree possible.

H. Licenses and Permits

(i) *General Licenses and Permits*

Tenants, including restaurant tenants, are ordinarily responsible for obtaining all governmental licenses and permits required for the lawful conduct of its business.

These may include, without limitation, the following:

a. Business Privilege Permit

b. ADA (Americans With Disabilities Act) Permit

c. Zoning Permit/Use and Occupancy Permit

(ii) *Restaurant-Specific Licenses and Permits*

In addition to the foregoing licenses and permits, restaurant tenants in particular are ordinarily required to obtain the following:

a. Department of Health Permit

Obtaining a Department of Health Permit and maintaining the highest rating available from such department is an absolute necessity. To obtain such a license, the tenant will need to ensure the cleanliness of the restaurant and that appropriate protocols for the handling and storage of food, especially raw food, are in place and are religiously followed. Prior to opening, the tenant must fully apprise itself of the rules and regulations of the local Department of Health applicable to the restaurant. From the landlord's perspective, failing to obtain a Department of Health License, and maybe even failing to maintain the highest rating available from the local Department of Health, should be listed in the lease as a material default.

b. Liquor License

Often, a lease will be conditioned upon the tenant's ability to obtain a liquor license within a stated period following execution. In such a case, the parties need to be mindful of the fact that certain costs and expenses, such as fit-out expenses, may need to be incurred prior to this date while the lease may ultimately be terminated due to the tenant's inability to obtain a liquor license. A well-crafted lease will address the parties' respective responsibilities for such costs, should they be incurred. Many times, the parties will simply agree to not incur such costs unless and until a liquor license is obtained. However, this is not always possible.

The issuance of a liquor license involves a thorough review of the criminal and business history of the proposed license holder as well as an inspection of the demised premises and the improvement plans for the demised premises. The local issuing authority will have a series of requirements pertaining to the physical characteristic of any venue in which

alcoholic beverages will be served. Examples of these requirements include suitable means of ingress and egress, way-finding, and fire suppression and security systems. Therefore, where the landlord is responsible for the cost of such improvements, a lease that is conditioned upon the tenant's ability to obtain a liquor license should also address who is responsible for such costs in the case of a termination due to a failure of such a condition.

Sometimes, the landlord may wish to have the option to obtain a liquor license on the tenant's behalf, especially where the tenant has first failed to do it on its own. Some jurisdictions allow for such an arrangement, and sometimes this is only possible where the lease is re-cast as a management agreement between the parties.

Leases often grant the landlord a security interest in the tenant's liquor license and provide that the liquor license if forfeitable upon an event of default of the lease by the tenant.

In most jurisdictions, there are varying types of liquor licenses. A restaurant that serves alcoholic beverages to hotel rooms and stocks mini bars, for example, may require an entirely different type of liquor license than a traditional restaurant that serves alcoholic beverages.

Liquor license law is created and enforced by local liquor licensing authorities. This body of law varies significantly from jurisdiction to jurisdiction. The types of licenses may vary significantly, and the requirements of the issuing authorities are often arcane and confusing. Therefore, obtaining the counsel of a local liquor license attorney is critical.

I. Initial Working Capital

Unlike other types of leases, restaurant landlords will often share a significant amount of the cost of the tenant's initial capital needs. These costs may take the form of a sizable tenant improvement allowance, a turn-key fit out or even a funded operating account.

Where the lease is really just a management agreement in disguise, such expenditures by the landlord reflect an investment in the restaurant upon which the landlord anticipates receiving a reasonable return on investment.

J. Loans

Under certain circumstances, such as where the restaurant's operations are temporarily affected in an adverse manner due to an unanticipated event, the landlord may, at the landlord's discretion, extend working capital to the tenant in the form of a loan.

K. Insurance Requirements

Like other commercial tenants, a restaurant tenant will typically be required to maintain the following types of insurance:

(i) Commercial General Liability insurance.

(ii) Property Insurance (covering all leasehold improvements, trade fixtures and personal property in the demised premises).

(iii) Workers' Compensation and Employer's Liability insurance (affording statutory coverage and containing statutory limits).

A restaurant serving alcoholic beverages will be required to maintain Liquor Liability insurance or "dram shop liability" insurance as well. This insurance covers claims relating to the sale, use or giving away of any alcoholic or other intoxicating beverages. Liquor Liability insurance is costly and, where the restaurant operator fails to abide by the requirements of the local liquor licensing authority, such insurance is readily revocable.

L. Subordination and Attornment

From the landlord's perspective, having the ability to subordinate the lease to the lien of all current and future

mortgages is critical. Without this right, the landlord would not have the ability to obtain financing secured by the building or to refinance any such debt. The tenant, on the other hand, often cannot take the risk of making a significant investment into the demised premises without the assurance that it will obtain the benefit of such an investment if the landlord defaults on its mortgage financing.

The traditional arrangement, where the tenant subordinates its lease to the lien of a mortgage and agrees to attorn to the lender (or any subsequent purchaser of the lender's interest in the lease) in consideration for the lender's (or such subsequent purchaser's) agreement to honor the lease, is a practical and common solution to this dilemma.

A tenant must fully-appreciate the ownership structure of the building in order to ensure that it is obtaining the covenant of non-disturbance from both the right and all necessary parties. For example, if the landlord is a ground lessee of the property, without a recognition and non-disturbance agreement from the ground lessor, upon a termination of the ground lease, for any reason, the lease will be wiped out as a matter of law, notwithstanding that the landlord's lender provided the tenant with a non-disturbance agreement. Likewise, where the land is financed by one lender and the improvements are financed by another, the tenant will need a covenant of non-disturbance from the lender whose loan is secured by a lien on the land and from the lender whose loan is secured by a lien on the building.

The importance of understanding the ownership structure as well as the parties involved and their respective roles cannot be understated.

M. Assignment and Subletting

The right to assign one's lease or to sublet one's demised premises is an important right. It is not only a viable exit-strategy if things don't go well for the tenant, it is also necessary should the tenant desire to sell its business during the lease term. If the tenant is a franchisee, its franchise agreement will invariably require that the franchisor have the ability to assume the franchisee's lease under certain circumstances, such as a breach by the franchisee under its franchise agreement, as well.

From the landlord's perspective such rights are disfavored. In a shopping center, for example, the landlord may have determined that a certain type or brand of restaurant is important to the mix of the shopping center. Allowing a different brand or type of restaurant to operate in the tenant's space may disrupt that mix. Allowing an entirely different use to operate in the tenant's space would likely be even more disruptive to the landlord's plans. Also, in all likelihood, the landlord underwrote the tenant's lease based, at least in part, on the brand, as well as the tenant's financial condition. If assignment or subletting rights are too liberal, the landlord may inadvertently end up with a tenant that does not satisfy its underwriting criteria.

The landlord's concerns can often be addressed by providing that the landlord need not grant its consent to an assignment where the landlord determines that the assignee is unsatisfactory due to stated pre-determined criteria, examples of which may include the following:

(i) That the assignee or subtenant desires to use the demised premises for a purpose other than the purpose permitted under the lease.

(ii) That the assignee or subtenant, in the landlord's reasonable judgment, does not have sufficient business experience, does not have a sound financial condition, or is not creditworthy.

(iii) That the assignee or subtenant, in the landlord's reasonable judgment, is not willing or able to operate the premises at the same level of service as the tenant.

(iv) That the assignee or subtenant has a financial net worth that is less than that of the tenant or that is, in landlord's reasonable judgment, insufficient to satisfy the financial covenants under the lease.

The tenant concerns are often satisfied where the landlord agrees that:

a. In the absence of any deemed unsatisfactory criteria, the landlord's consent to an assignment or a

sublet will not be unreasonably withheld, conditioned or delayed.

b. The landlord's consent to an assignment to the tenant's franchisor shall not be required.

c. The landlord's consent to an assignment or sublet shall not be required where the assignee or sublessee is: (*x*) an affiliate (i.e., a corporation or other entity 50% or more of whose capital stock or other ownership equity is owned (directly or indirectly based on tiered ownership) by the same stake holders owning 50% or more of tenant's capital stock or other ownership equity), parent or wholly-owned subsidiary entity of tenant; or (*y*) an entity to which the tenant sells or assigns all or substantially all of its assets or stock or membership interest or with which it may be consolidated or merged.

Sometimes, however, the landlord cannot take the risk associated with accepting an assignment or sublet. In those instances, the landlord will insist on the right of recapture upon a tenant's request to assign the lease or sublet the whole of the demises premises.

Contrary to a typical retail lease, in a restaurant lease, it is not uncommon that the tenant be obligated to reimburse the landlord for the landlord's unamortized capital improvement costs upon a recapture.

N. Key Person Obligations

Unlike other types of retail operations, restaurants are often associated with a particular person, be it the chef, the manager or sometimes a celebrity spokesperson. These parties create buzz around the restaurant, attract the public, and help to give the restaurant a certain personality and cachet.

Whether a restaurant succeeds or fails is often dependent on the key person's participation in the kitchen, the dining room, at media events, in advertisements, or at other promotional events. For this reason, it behooves the landlord to mandate that the key person participate in the restaurant's operations to a reasonable degree. This participation is typically referred to in a restaurant lease as the "Key Person Obligations."

Key Person Obligations vary from restaurant to restaurant, depending on the particular role of the party, the nature of the restaurant, and other factors. Typical Key Person Obligations include the following:

(i) Participation in Pre-Opening Activities.

(ii) Overseeing the launch of the restaurant.

(iii) Attending marketing and promotional events (especially in conjunction with the initial launch of the restaurant).

(iv) Attending openings (soft and actual).

(v) Being present in the dining room or kitchen, depending on the role of the Key Person, during meal service (at least some of the time).

Where possible, the landlord should seek to prohibit the Key Person from developing, owning, operating or providing services to competing venues with close proximity to the restaurant so as to keep the buzz and attention on the restaurant rather than on a competitor.

O. Use of Names, Websites and Intellectual Property

(i) *Use of Names*

Especially where the restaurant is located in a hotel or other venue, it may be tempting to incorporate the name of the hotel or other venue into the restaurant's name or vice versa. However, allowing one's registered trademark to be shared or used in such a way can have a deleterious effect on the trademark. Also, where one determines that its trademark is being infringed, it is absolutely critical one enforce its trademark in order to protect it.

Parties may nevertheless conclude that it is beneficial to share trademarks under certain circumstance, for example, when identifying the location of a restaurant within a larger venue (e.g., Restaurant Guy

Savoy at Caesars Palace). In such a case, the parties should consider entering into a written agreement outlining the specific parameters of such an arrangement. Such an agreement, if done properly, will allow the shared use of a trademark without diluting or jeopardizing its effectiveness. This type of agreement can be included in or exist independent of the lease. If this agreement is an independent agreement, it should be cross-defaulted with the lease and automatically end upon the end of the lease, whether by expiration or termination.

(ii) *Websites*

Where the restaurant is located in a hotel or other venue, it is often necessary that the parties' respective websites be linked to one another. Where this is the case, each party may wish to retain some degree of control over the other party's website content, especially where one's website contains content that describes the venue or services of the other party. These rights of the parties should be addressed in the lease.

(iii) *Other Intellectual Property*

Parties to a lease may have reason to share other intellectual property beyond the names and trademarks. Shared intellectual property may be useful in connection with promotional events, the sale of merchandise and in advertising. Where one's intellectual property is to be shared or jointly used by the parties to a lease, in order to protect one's rights to such intellectual property, the lease or other agreement governing such use should specifically outline the parameters of such use.

P. Exclusive Rights

Most retail tenants will seek the right to be the exclusive provider of a particular product or service within a given area surrounding their demised premises. When it comes to restaurant tenants, this is even more common. Depending on the location of the demised premises, the service being offered, and other factors, this is achievable to varying degrees.

Often, a landlord will grant a tenant an exclusive that is very particular and narrowly tailored. In the case of a pizza parlor in a shopping center, for example, a landlord may grant the tenant an exclusive on the sale of pizzas at the shopping center and within a given area surrounding their demised premises (in case the landlord owns or develops other properties beyond the shopping center) while exempting from that exclusive pizzas sold at any supermarket or higher-end restaurant located at any properties owned by the landlord, including the shopping center in which the tenant's demised premises are located.

A tenant with an exclusive use clause must have the right to enforce that clause through an injunction or other means (e.g., a remedy for damages). Moreover, where the landlord has a hand in violating the tenant's exclusive, the tenant should have remedies against the landlord itself, such as the right to injunctive relief, the right to abate all or a significant portion of its rent pending abatement of the violation, and/or the right to seek damages from the landlord.

Q. Outside Seating

Outside seating is a popular trend and many restaurant tenants, especially now, will seek this right in connection with their lease. Outside seating areas may be outside of and not included within the definition of the demised premises described in the lease. Therefore, it is important that the lease address the respective responsibilities of the parties regarding this area.

The tenant may be granted the use of an outside seating area without the obligation to pay rent for such space. Conversely, the landlord may wish to include this space within the definition of the "demised premises" and/or "tenant's proportionate share" under the lease in order to charge tenant basic rent and/or additional rent for such space.

The lease should also clearly provide whether the landlord or the tenant is primarily responsible for accidents

and other events occurring at the outside seating area, if any.

If the outside seating area is not a part of the demised premises, the tenant should seek to include an exclusive use license for such space in its lease.

So long as the parties carefully address all of the issues that pertain to the tenant's use of the outside seating area, an outside seating area can be a worthwhile value-added amenity that can boost the tenant's sales, drive traffic to the landlord's property, and, in the age of COVID-19, may mean the difference between a restaurant's ultimate success and failure.

R. Right to Soft-Opening

A tenant will want to the right to conduct a soft-opening without triggering the rent commencement date. Since most commercial leases provide that rent begins on the sooner of (i) a predetermined number of days following the delivery of the demised premises to the tenant or (ii) on the date the tenant commences business with the public in the demised premises, if not otherwise addressed in the lease, a soft-opening may in fact trigger the rent commencement date.

A soft-opening may need to occur before all of the improvement work to the demised premises is completed. Therefore, when the landlord is the party prosecuting such work, the landlord should condition the soft-opening on such opening not unreasonably interfering with the completion of landlord's work.

Moreover, to avoid potential liability, the landlord should further condition the tenant's right to conduct a soft-opening on the public being lawfully permitted to occupy the demised premises for such a purpose.

Finally, for reasons that are obvious enough, the tenant should not forget to invite the landlord's representatives to the soft-opening!

S. Performance Standards/Termination Events

(i) *Performance Standards*

It is always important to the landlord and the tenant that the restaurant succeed. After all, the tenant wants to create a successful business and earn a profit. The landlord on the other hand wants to collect the rent – all possible rent! If the restaurant fails, neither party achieves its goal.

Where the restaurant lease is functionally a management agreement, if the restaurant fails to earn a certain net revenue, the landlord will additionally fail realize a return on its capital investment.

Where the restaurant serves other functions which are integral to the operation of the larger venue in which the restaurant is situated, such as room service, for example, it is especially important to the landlord that the restaurant remain strong and maintain its ability to perform its functions well.

Many restaurant leases will allow the landlord to terminate the lease, in order to replace the operator, if certain performance standards (typically, pre-determined gross sales thresholds) are not met. These standards will vary depending on the tenant's projections and the landlord's capital investment, and are ripe for negotiation between the parties. The more informed the landlord is about the tenant's business, the better situated it is to set such benchmarks correctly.

(ii) *Termination Events*

As stated above, the landlord will typically retain the right to terminate the lease where certain performance thresholds are not achieved by the tenant. Other circumstances permitting the landlord to terminate the lease are typical as well, especially where the demised premises are situated in a hotel or other venue. These include, without limitation, the following:

a. The sale of the hotel or other venue (where the transferee of the landlord's interest in the property does not wish to continue the restaurant).

b. Following a casualty to the demised premises (where the landlord elects, and is permitted to

elect, not to restore the demised premises).

c. Following a material breach of the lease by the tenant.

In the case of a termination due to a sale of the hotel or other venue, a modest termination fee is typically payable to the tenant (e.g., 1x – 2x trailing 12-month gross sales).

Where the lease is terminated following a casualty or the tenant's breach of the lease, in nearly all cases, no termination fee is payable to the tenant.

Less frequently, the landlord will retain the right to terminate the lease for any reason or no reason at all. In such a case, a sizable termination fee is typically payable to the tenant (e.g., 3x – 5x trailing 12-month gross sales).

T. Tenant Guarantees

The tenant under most restaurant leases is merely a shell entity with little or no assets beyond the lease, the furniture, fixtures and equipment situated in the demised premises and, sometimes, a liquor license. This makes a tenant guarantee an important component of the lease for the landlord.

Guaranties attached to restaurant leases usually take one or two possible forms – a Full Guaranty or a so-called "Good-Guy" Guaranty.

(i) *Full Guaranty*

The Full Guaranty is a written agreement signed, contemporaneously with the lease, by one or more of the principal(s) of the tenant, which provides for the repayment of all of the tenant's monetary obligations under the lease. That said, the Full Guaranty sometimes contains less than a full guarantee. For example, in contrast to a guarantee for "the repayment of all of the tenant's monetary obligations under the lease," the Full Guaranty may limit the guarantor(s)' responsibility to the repayment to "not more than 2 years' worth of rent." This guarantee, while less than a full guarantee of the tenant's monetary obligations under the lease, remains distinguishable from a "Good-Guy" Guaranty for reasons stated below.

The Full Guaranty is typical of retail leases in general. However, when it comes to restaurant leases, the more prevalent guaranty attached to the lease is the "Good-Guy" Guaranty.

(i) *"Good-Guy" Guaranty*

The "Good-Guy" Guaranty is a written agreement signed, contemporaneously with the lease, by one or more of the principal(s) of the tenant, which provides for the payment of the tenant's monetary obligations under the lease "up to the date that the tenant vacates the demised premises and surrenders possession of the demised premises to the landlord."

This is referred to a "Good-Guy" Guaranty because the guarantor is facilitating the return of the demised premises to the landlord and therefore being a "Good Guy." A "Good Guy" Guaranty will often mandate that the tenant surrender all furniture, fixtures and equipment to the landlord as well. A well-crafted "Good Guy" Guaranty will also hold the guarantor(s) liable for any damages the landlord may suffer due to a breach of the "Good Guy" Guaranty as well as the tenant's failure to perform any/all post-closing obligations of the tenant.

Where there is more than one individual guarantor, each individual guarantor should be jointly and severally liable for all of the obligations described in the "Good Guy" Guaranty.

Quickly obtaining the return of possession of the demised premises, in a fully fit-out manner, so that the landlord can re-lease the demised premises to a replacement operator, is ordinarily the best means for the landlord to mitigate its damages following a restaurant tenant's default. For this reason, the "Good Guy" Guaranty has become the industry standard.

(ii) *"Bad-Boy" Guaranty*

While not as common as the other two types of guaranties describe above, a third type of guaranty, called the "Bad-Boy" Guaranty, is sometimes used in connection with a restaurant lease. The "Bad-Boy" Guaranty is a written agreement signed, contemporaneously with the lease, by one or more of the principal(s) of the tenant, which provides for the repayment, in full, of all of the tenant's monetary obligations under the lease, but only upon the occurrence of certain "bad acts" on the part of the tenant, examples of which include, without limitation, that upon vacating the demised premises the tenant removes equipment from the premises belonging to the landlord; that the tenant returns the demised premises to the landlord significantly damaged; and that despite the existence of a "Good Guy" Guaranty, the tenant fails to timely vacate the demised premises following an event of default of the lease by the tenant.

Absent the commission of any bad acts by the tenant, the landlord is left with a "Good-Guy" Guaranty.

To avoid confusion, it is helpful to articulate in the guaranty what acts specifically constitute so-called "bad acts."

U. Post-Termination Obligations

Unlike other types of leases, restaurant leases typically contain a number of tenant obligations, beyond mere indemnity obligations, that survive the end of the lease.

Typical Post-Termination Obligations include:

(i) Providing the landlord with a final accounting of all sales and expenses, including a true-up of all fees and rents payable under the lease.

(ii) Providing the landlord with all books and records of sales and expenses not previously provided by the tenant.

(iii) Removing all links to the landlord's website from the tenant's website.

(iv) Returning all unsold merchandise bearing the landlord's logo or trademark.

(v) Assisting landlord with the transition of the restaurant operations to the new operator.

Due to the importance of these tasks, typically, the tenant will not be released from its obligation under the lease, and the guarantor(s) will not be released from the responsibility for all of the tenant's monetary obligations under the lease, even where the guarantor(s) have executed a "Good Guy" Guaranty rather than a Full Guaranty, unless and until all of these obligations have been satisfied.

3. WORK LETTERS

he work letter addresses the parties' relative responsibility for the improvement work to the demised premises and the cost of such work. Work letters often include technical jargon which is not readily understandable by someone outside of the construction industry. Work letters come in many different forms and contain an array of different information. Some are very basic while others are quite complex. Some work letters describe turnkey fit-outs, some allowance deals, and some a hybrid of the two. Work letters impact and sometimes even amend provisions of the lease. The delivery date and rent commencement date, for example, are often impacted by the pace of the improvement work and the party responsible for any work delay. Landlords, who are the primary authors of work letters, often have construction professionals on staff or readily available to assist with the preparation of work letters. These professionals tend to help the landlord craft the work letter in a way that inures to the landlord's advantage. For all of these reasons, a tenant is well advised to hire a construction manager, architect or other similar professional, with significant experience reviewing any analyzing work letters, to assist with the review and negotiation of the work letter.

4. CONCLUSION

Restaurant leases are complex legal documents. They contain and address a myriad of issues. Therefore, in order to successfully construct and draft a restaurant lease, the practitioner will need to be familiar with not only the concepts that pertain to a typical commercial lease, and the concepts that pertain to a restaurant lease in particular, but also with the operational issues and other factors which contribute to a successful restaurant.

Despite the hard work and good intentions of operators, most restaurants fail to meet their potential. While a handful of restaurants enjoy tremendous success, this is the exception not the rule. Moreover, the COVID-19 pandemic has made the likelihood of opening and operating a successful restaurant significantly more challenging.

Only when one has the good fortune to have the right business plan, the right concept, the right deal, the right location, the right timing, the right menu, the right management, the right staff, the right professional, and of course, the right lease, will one succeed. That's a lot of "haves!"

The knowledge gained from this piece will help practitioners construct and draft a restaurant lease that will hopefully shift the odds of his/her client's success ever so slightly into the winning column.

Bon appetite!

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