

# LEASING CONSIDERATIONS FOR FOOD SERVICES

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## Leasing Considerations for Food Services

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## A. LEASE STRUCTURE

- In many instances, a new full-service restaurant will tend to be leased either on a ground lease or reverse build-to-suit basis. Because of the unique use and build-out of a restaurant, many tenants prefer to control the construction themselves. A ground lease may also be popular because the Tenant desires to finance its construction through use of a leasehold mortgage. A Landlord who has contributed a substantial sum towards construction—either by building out a shell or in a reverse build-to-suit scenario—will be less likely to consent to a leasehold mortgage than a Landlord who is simply leasing land and leaving construction up to the Tenant. Quick-service and other food use tenants (such as a coffee or juice concept) will most likely be in-line spaces where the Landlord constructs the shell. In any event, a food use Tenant will want to make sure that its unique “trade dress”—i.e., look and feel—are incorporated into the building design.

## B. PREMISES

- In addition to the space actually leased, the Tenant may have the right to use of an outdoor dining area on either an exclusive or non-exclusive basis. The Lease should specifically define Tenant's rights with respect to this usage, and what costs or obligations—if any—the Tenant has. For example, a restaurant tenant may be granted an exclusive outdoor dining area as part of its Premises and while fixed rent may not be payable on the area, the Landlord may (and often does) require that the outdoor dining area is included in the computation of the Premises for the purpose of calculating Tenant's share of Common Area Expenses, Taxes and Insurance. Or, the Landlord may simply place some tables and chairs in front of a couple of spaces and permit all of the tenants' customers to utilize this amenity. The costs attributable to these tables and chairs might be in Common Area Expenses, or the Tenant may be required to maintain and replace. In another circumstance, the Landlord might establish a common food court usable by several food use tenants—in such a circumstance there is often an additional component of Common Area Expenses attributable to the food court which is billed solely to the food use tenants.

## C. CONSTRUCTION CONSIDERATIONS

- In addition to more complicated provisions regarding use, a food use's biggest complicating factor is its construction. More so than a normal retail tenant, a food use tenant located in a space built by the Landlord must be very cognizant of the construction of the building it is going into and what effect that construction might have on its own build-out both as to cost and timing. For example, in a multi-level building, a first floor food use tenant may incur significant costs and time delays if there is not adequate venting or utilities available to the space and ducting and lines must be run at a considerable distance. In any circumstance, a food use tenant will most likely require additional utility capacity (including, but not limited to, electricity, water, sewer and gas) above that of a normal retail tenant and the Tenant's counsel should confirm (in connection with Tenant's construction personnel) that the utilities available to the space are adequate to meet the Tenant's needs. For example, unless HVAC is provided by a gas unit, most retail tenants do not require gas service at all while most restaurant tenants will need gas for cooking.

- In addition, most food uses (not all) will be required to utilize a grease interceptor or grease trap through which its water is filtered before dumping into the sewer. (Examples of tenants that normally are not required to use a grease interceptor are a coffee store like Starbucks, a juice store like Jamba Juice or a deli sandwich shop where food is not cooked, like Subway.) If a grease interceptor is already in place (either from a prior occupant or because it has been installed by the Landlord) the Tenant should make sure that the existing unit is of adequate size to meet its needs and that of any other occupants who may share the unit and that it is in good working order. If the Tenant is required to install the grease interceptor, the Lease should provide the right of the Tenant to install the grease interceptor in a mutually-acceptable location. In many newer centers, governmental agencies are requiring developers to install centralized grease interceptors and the Tenant should make sure that a connection to the grease interceptor is provided as part of Landlord's Work. In any event, the Lease should

provide for who is responsible for the on-going maintenance and clean-out of the grease interceptor (i.e., whether the Tenant is responsible to clean out its own interceptor, whether the interceptor is maintained on a shared basis by the Landlord and included in Common Area Expenses, or whether the cost is shared only by the tenants utilizing the interceptor).

- A food use tenant also must be aware of local codes and ordinances which may increase its costs of construction. For example, some jurisdictions will require the use of "scrubbers" to clean the exhaust from the food use. Not only are such installations costly to construct in the first instance, but for a larger restaurant monthly on-going maintenance costs may top \$5,000.
- Consideration must also be given to the location and size of trash facilities, as the waste generated by a food use is not only larger but of a different type than retail tenants. In warmer climates, some landlords will require that restaurant waste be kept cool until it is

- picked up by the trash company so as to avoid unpleasant odors and vermin. The food use Tenant should confirm the availability of trash facilities (and whether it is exclusive to the Tenant or shared) and that the trash facility (especially when shared) is sufficient to meet the Tenant's needs.

## D. PERMITS AND LICENSES

- A food use potentially has several layers of licensing requirements that a normal retail tenant does not have. In addition to the normal building permits and city business licenses, a food use will also have hurdles to overcome with respect to health licenses, and if the use involves sale of alcohol, a liquor license. Usually, a restaurant's lease is not contingent on the obtaining of health licenses, but is contingent on liquor licenses. Most jurisdictions, however, will not issue the actual liquor licenses until just before the restaurant is ready to open for business (so final inspections can be made of the facility) and it is not practical for either party to have an open contingency throughout the entirety of the restaurant build-out. Therefore, most liquor license contingencies give the Tenant a certain period of time after lease execution in which to determine whether it is likely to obtain a liquor license, subject, of course, to satisfaction of specific requirements regarding build-out and operation. If the Tenant cannot satisfy itself within that time period that a liquor license can be obtained, then it has the right to terminate the Lease without penalty.

## E. TERM

- Although there may be exceptions for tenants with a lot of leverage, most non-restaurant tenants will likely have terms commensurate with other non-food use tenants. Even a restaurant tenant in an in-line space or reverse build-to-suit space, however, will definitely need a longer term than normal so as to be able to amortize its "larger than a retail tenant" investment over the life of the lease. A ground lease tenant will typically need and get an even longer term as it is contributing a substantial sum to build its building from the ground up and install its improvements.

## F. RENT

- As with many retail leases, many restaurant leases contain provisions for the payment of Percentage Rent. In addition to determining whether it is appropriate to base the Percentage Rent payment on an unnatural breakpoint, food use leases usually contain additional exclusions from gross sales that other retail uses do not need.
- Examples:
  - Tips to employees.
  - Discounted (or free) meals to employees.
  - Discounted coupons for meals.
  - Walk-outs (i.e., customers who skip out on the bill).
  - Donations to charities.
  - Gift certificates.

## G. USE

- Especially in a large center, the Landlord will want to specifically define the type of food use which the Tenant will conduct—in order to avoid duplication of uses in the center, violation of exclusives and to offer the center's customers a variety of dining options. On the other hand, the Tenant wants to retain some flexibility to respond to the wants and needs of its trade area—it could be disaster if the Tenant opens, for example, a Hawaiian BBQ restaurant only to find that this type of cuisine does not have an audience in the trade area. In such a circumstance the Tenant may want to tweak its menu to emphasize more of a Chinese or Japanese bent—but if the Lease has been properly drafted from a Landlord's viewpoint, the Tenant will not have this flexibility without Landlord's consent.

- Common compromises:
  - i. Tenant has the right to make minor changes to its menu (subject to the rights of other existing tenants who might have exclusives) but cannot change the overall "concept" of the restaurant without Landlord's consent.
  - ii. Tenant has the right to change the concept of the restaurant to another concept already within its family of restaurants (i.e., a national or regional chain that may have several different nameplate restaurants).
  - iii. Tenant has the right to change the concept of the restaurant to another concept so long as the change does not violate an existing exclusive and/or duplicate the primary use of another existing tenant.

- In looking at use, a Tenant's counsel should carefully review any restrictions in a Declaration of Covenants, Conditions and Restrictions or other recorded instrument applicable to the property. In some instances, there are limitations on the amount of alcohol or other products a tenant can sell. Tenant's counsel should also request copies of all exclusives applicable to the center to ensure that the Tenant's intended use will not violate any of the exclusives and that there is adequate flexibility to allow the Tenant to modify its menu to meet changing business needs.

## H. EXCLUSIVES

- Many food use tenants will insist on an exclusive to protect themselves from competition. Both the Landlord and Tenant should carefully craft any such exclusive, as it is sometimes difficult to define exactly what a Tenant is trying to protect. The exclusive cannot be drafted broadly just to say that someone operating a competing business would violate—food is food; an Italian restaurant would not necessarily compete with a Denny's. However, Denny's might have on its menu certain items that could be considered "Italian"—i.e., spaghetti and meatballs-- and the Landlord needs to make sure that adequate exceptions are drafted into any exclusive to permit its other tenants to operate their businesses (and the Landlord to lease its other spaces). Therefore, it is usually best to tie an exclusive to a business which "primarily" operates for a certain type of cuisine, if that is possible to define (i.e., primarily operate as a Chinese restaurant, primarily sell hot dogs, etc.). It is important to try to avoid an absolute prohibition against selling a particular menu item, because as regional and national tenants modify their menus to meet changing consumer needs they should not be restricted from being able to offer an item on an incidental basis.

- There are also exclusives that tie to a certain number or type of menu items, or that tie to a certain type of cuisine in combination with a particular type of alcohol sales (i.e., "operation of Mexican restaurant offering a tequila bar with at least 50 types of tequila").

## I. RADIUS RESTRICTIONS

- Similar to the discussions on exclusives, the parties need to be careful in defining a radius restriction. Since these clauses are usually drafted in a "dragnet" style to not only restrict the actual Tenant, but also its affiliates, care must be taken by the Tenant that it does not inadvertently put itself in a hole. For example, Darden Restaurants' current concepts include Red Lobster, Olive Garden, Bahama Breeze, and Smokey Bones. Most people would agree that a seafood house does not necessarily compete with a BBQ restaurant. However, unless the radius restriction is tied to another restaurant that primarily offers seafood (or alternatively is tied to a trade name) then a Landlord may argue that the two concepts are competing businesses as they are both competing for the same food customer.

## J. TENANT FINANCING

- More so than most other retail uses, a food use Tenant needs the ability to finance or lease its equipment without necessity of Landlord's consent. Restaurant equipment is very expensive and it is most likely that the Tenant will not be purchasing such equipment outright.
- In a ground lease situation, the Tenant also needs the right to place a leasehold mortgage in order to have the flexibility to finance its improvements. From the Landlord's viewpoint, it will want the lender/lessor of the equipment to agree to some basic terms, such as that the lender/lessor will give notice prior to removing equipment and will repair any damage arising from the removal.
- For some chain tenants, we are seeing more and more where the Tenant has entered into a collateral assignment of all of its tangible and intangible property in order to secure a large multi-million dollar line of credit. In such a circumstance, the Tenant must be sure that its Lease does not restrict such an assignment or if it does that there are reasonable restrictions on Landlord's right to consent.