

R E A L E S T A T E

REVIEW

Fall 1997

Subordinate Mortgage Financing:
The Perils of the Senior Lender

The Internal Contradictions of Hotel REITs

Structuring a "Win-Win" Lease Recast

The Shopping Center Percentage Lease:
Part 3—Enforcement

Catalog Store Use and Exclusive Clauses:
Part 2

Life Cycle of a Net-Leased Property

The Flat Tax and Real Estate Values:
Renewing the Debate

Mediation of Disputes in the Real Estate
and Construction Industries

Attributes of Tomorrow's Warehouse Structures

The Growing Variety of Alternative
Home Mortgage Options

Home Mortgage Marketing:
Selling the Same Product for Different Prices

The Dispute Over Residential Short Sales

The Rehabilitation Tax Credit:
A Neglected Tax Relief

Local Real Estate Demand
in a Globalizing World

Editor's Corner

Real Estate Appraisal in the 1990s

Law and Taxation

Executive Compensation



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SUBORDINATE MORTGAGE FINANCING: THE PERILS OF THE SENIOR LENDER

Joshua Stein

3

Despite the risks, senior lenders may find attractive benefits.

THE INTERNAL CONTRADICTIONS OF HOTEL REITS

R. King Burch and R. Steven Taylor

10

Are the disfunctions systemic or are they curable misalignments?

STRUCTURING A "WIN-WIN" LEASE RECAST

Charles S. Isaacs

19

Recasting a lease to assure stability of occupancy can benefit both landlord and tenant.

THE SHOPPING CENTER PERCENTAGE LEASE: PART 3—ENFORCEMENT

Mitchell Y. Herman

25

The best remedy for the breach of "exclusives" is the correct use of liquidated damage provisions.

CATALOG STORE USE AND EXCLUSIVE CLAUSES: PART 2

Emanuel B. Halper

29

Landlords must solve the infinitely varied use clause problems created by many types of catalog stores.

LIFE CYCLE OF A NET-LEASED PROPERTY

Leonard A. Cline

34

No one can anticipate the vicissitudes of 54 years.

THE FLAT TAX AND REAL ESTATE VALUES: RENEWING THE DEBATE

James A. Fellows and Harinder Singh

39

The flat tax is not a "dead issue," but the jury is still out on its ultimate effects.

MEDIATION OF DISPUTES IN THE REAL ESTATE AND CONSTRUCTION INDUSTRIES

Gerald S. Clay and James K. Hoenig

46

Mediation is designed to avoid the cost, risk, and stress of litigation.

ATTRIBUTES OF TOMORROW'S WAREHOUSE STRUCTURES

Marvin F. Christensen, Bill Wisener and Darrell J. Campos

51

Tenant perceptions of changes that will meet their needs.

THE GROWING VARIETY OF ALTERNATIVE HOME MORTGAGE OPTIONS

Roger P. Sindt and Donald A. Nielsen

58

Innovation accompanies changing lenders' and borrowers' attitudes toward risk.

HOME MORTGAGE MARKETING: SELLING THE SAME PRODUCT FOR DIFFERENT PRICES

Joshua Buch and Kenneth Rhoda

64

Mortgage lenders profit from successfully differentiating their products.

THE DISPUTE OVER RESIDENTIAL SHORT SALES

Robert Vincent and Nathan Oestreich

70

Are the purchasers in these transactions Robin Hoods or robbing hoods?

THE REHABILITATION TAX CREDIT: A NEGLECTED TAX RELIEF

Bruce M. Bird and Joel B. Haynes

73

Property owners are unaware of or indifferent to the pass-through benefits of the rehabilitation credit.

LOCAL REAL ESTATE DEMAND IN A GLOBALIZING WORLD

Alan R. Winger

77

How local firms fare will depend on how well they adapt to changing conditions.

EDITOR'S CORNER

WHEN WILL THE NEXT DOWNTURN START?

Norman Weinberg

80

REAL ESTATE APPRAISAL IN THE 1990s

VALUE OF ENVIRONMENTALLY SENSITIVE LAND

Charles B. Warren

82

LAW AND TAXATION

SECRET LIENS

Edward I. Foster

85

EXECUTIVE COMPENSATION

COMPARING AND VALUING LONG-TERM EXECUTIVE INCENTIVES

Patricia A. Mitchell

89

CATALOG STORE USE AND EXCLUSIVE CLAUSES: PART 2

Landlords must solve the infinitely varied use clause problems created by many types of catalog stores.

EMANUEL B. HALPER

hopping center catalog store use and exclusive clauses present unusually difficult problems for two reasons: (a) No one knows for sure what a catalog store is, and (b) Constantly changing consumer tastes make it necessary for catalog store owners to demand very broad use rights.

Many different kinds of stores call themselves catalog stores. Catalog stores come in many sizes and shapes, and they sell a vast variety of merchandise. The principal theme that ties them together is that the store (or the chain of which the store is a member) conducts both a catalog business and a retail store business.

The second reason that catalog store use and exclusive clause negotiations are so difficult originates in the relationship between the catalog and the retail operation. This relationship causes some catalog store tenants to reach for use clauses that can violate a major principle of good shopping center husbandry, that the shopping center works best when it offers consumers an extensive variety of merchandise in different specialty stores.

A catalog store chain that believes it must coordinate its store offerings with its catalog is likely to demand a use clause that gives it the right to sell any catalog item from the store. It is convinced that the source of the consumer's interest in the store is the fame of the catalog. Even catalog store chains that make little effort to coordinate their catalogs and their stores rely on the catalog to discover potentially hot selling items for the stores. (The converse is true also; hot selling store items find their way to the catalog.)

THE PROBLEMS CREATED BY LAX USE CLAUSES

The tension in a negotiation between a landlord and a catalog store lies in finding a compromise between (1) the landlord's need to limit the tenant's product and service categories and (2) the tenant's need for flexibility. In the end, the tenant should not come away with an unrestricted right to sell any merchandise or perform any service, but the use clause should not excessively limit the tenant's right to change the kinds of merchandise it sells and the services it performs.

It frequently happens that, after a retail store chain enters a shopping center, its catalog lists products subject to restrictions in other tenants' exclusive clauses. No lease should give a shopping center landlord control of a tenant's catalog. However, if the tenant were to sell any of these products from its premises in the shopping center, the sale would violate one or more of the

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other tenants' exclusive clauses. It's not unusual for catalogs to list fancy food baskets, boxed chocolates, books, clothing, cosmetics, sporting goods, toys, housewares, and hardware, etc.

If a landlord concedes to an overly broad use clause in the lease of a prospective catalog store tenant, it might effectively be agreeing that the tenant will have the right to sell products that are already restricted by previously executed leases,¹ or it may cause difficulties with leases the landlord will negotiate in the future. The consequence of a lax use clause may be that the landlord becomes a defendant in two lawsuits. On the other hand, the overly broad use clause may make it impossible for the landlord to agree to exclusive clauses that will undoubtedly be requested by future tenants and result in the loss of lucrative potential leasing opportunities.

Finally, a use clause that gives a store the right to sell anything listed in the catalog gives that store the power to change its character. The tenant could abuse its rights by changing the character of its catalog, say, to one that duplicates another tenant's format and merchandise mix. Such an eventuality would not only impair the center's tenant mix, it would stir hostility among the tenants and create potential legal conflicts between use clauses and exclusive clauses.

Business Considerations

Negotiators trying to balance the landlord's needs with those of the potential catalog store tenant must keep four business rules in mind.

A shopping center's market appeal depends partly on tenant diversity. If many tenants have overly broad use clauses and choose to imitate other tenants, too many stores will come to look like the others and to sell the same stuff. Few customers want to browse through shop after shop with the same look and feel.

A shopping center's leasing program also depends partly on its tenants' diversity. Small store tenants are attracted to shopping centers by the prospect of filling consumer needs that are not yet completely filled.

Competition among category killers may be fatal. Although a large shopping center can absorb direct

competition between a few similar small stores, direct competition among large category killer units result in their killing one another and the landlord. Most shopping centers cannot support two food supermarkets. Small shopping centers are even more unlikely to support two home improvement centers, two super toy stores, two big-box furniture stores, or two super bookstores.

PROBLEMS CREATED BY EXCESSIVELY RESTRICTIVE USE CLAUSES

Excessive restrictions on a tenant's use amount to a lose/lose situation. Changes in consumer needs and attitudes can have a materially adverse effect on a tenant, and the adversity is magnified exponentially for a long-term tenant of a big store. A tenant that cannot change its merchandise mix in response to changed circumstances may be fatally damaged, and the death of any tenant's business must concern the landlord. Dead tenants don't pay rent. Moreover, as they are dying, they don't open for business every day, and they don't attract customers to the shopping center. So, the other tenants lose out too.

A landlord negotiating the use clause with a catalog store tenant should consider two factors: (1) the store's gross leasable area and (2) the kind of catalog store the tenant intends to operate.

The Size of the Catalog Store

Catalog stores range in size from huge operations that occupy free-standing buildings (big-box stores) to small stores of no more than 20,000 square feet. Massive store size alone suggests the need for a broad use clause. Merchants that sign long-term leases for large blocs of space usually operate multi-product businesses and have access to capital. They tend to demand the flexibility to add new merchandise categories or to change existing merchandise categories. Bitter experience has taught them about the erratic nature of consumers' buying preferences and the need for drastic merchandise mix changes. Today's hot products are forgotten quickly; some of them become tomorrow's dogs. Sometimes, consumer interest in an entire merchandise category declines significantly, suddenly and inexplicably. When that happens, they have two choices: (1) stick with the original merchandise mix and go out of business

or (2) change the merchandise mix and (hopefully) thrive.

The landlord should want to give a big-box catalog merchant the right to change its merchandise mix as long as the change doesn't result in duplicating another big-box merchant's operation, overwhelming smaller specialized stores, or violating another tenant's exclusive clause.

Small store catalog merchants are less able to make major alterations to their merchandise mix. The small specialized store's business purpose was always to serve a narrow market segment. The opportunity to serve that segment is what induced it to execute a lease in the first place. The desire to add that market segment to those served by the center induced the landlord to execute a lease. A good shopping center has many small specialized stores, and small specialized merchants are vulnerable to direct competition. Accordingly, it's appropriate for a landlord to be tougher with a small specialized catalog store's right to stray from its original mission and merchandise mix.

THE TYPE OF CATALOG STORE

The type of catalog and the type of store should also influence use clause negotiations. The compromises needed to reconcile landlords' and tenants' needs differ for different types of catalog stores.

Department Stores With Catalog Desks

Sears and Wards, formerly the major players, discontinued publishing their mammoth catalogs. Until they or other department store chains decide to reinaugurate general merchandise mail and phone order catalogs, most department store lease negotiators are unlikely to press catalog-based issues. However, the tenant's use rights that are part of most contemporary department store leases can be used to put the tenant into the catalog business. To put the issue another way, there's usually nothing in contemporary department store leases to stop a retailer from resuscitating a defunct catalog or from inaugurating a new catalog.

Department store use clauses usually assert the principle that the premises may be used for any legal retail purpose. That right is meant to be exercised constructively to enable the tenant to create a general merchandise store (a department store). However, the unfettered right to use the

premises for any legal purpose also permits the department store tenant to convert the store from a big seller of general merchandise to a big specialized store, that is, to become a "category killer." As indicated previously, the presence of two or more competing specialized big-box stores in a small or

medium-sized shopping center is likely to destroy at least one of them, and hurt the center as well.

Another problem lurks in the unfettered right to use the premises for any legal purpose. The tenant may decide to carve small stores from the huge space it leases. If some of the carveout stores duplicate and compete with the other specialized small stores, they subvert the shopping center's market strategy, diminish its customer appeal, and unbalance the small store mix. And, of course, the uses of the new stores created on the department store premises may conflict with restrictions in the exclusive clauses of the other tenants.

Although the tremendous bargaining power of prospective department store tenants compels landlords to accept the basic principle that the department store should have the right to use the premises for any legal purpose, prudent landlords should be able to negotiate some easy-to-swallow limitations on the department store's use.

- If the shopping center already contains one or more category killers, the landlord should bargain for a restriction against converting all or part of the department store into a competing category killer.

- The landlord should also try to prohibit the department store from carving small stores from its premises. (It might settle for a clause that prevents the creation of certain types of specialized stores that are already located in the center or may be in the future.)

The department store lease should recognize some of the existing restrictions of specialized tenants that prohibit the sale of their core products. Examples are supermarket restrictions against the sale of certain food and beverages for consumption away from the shopping center and drugstore restrictions against the sale of prescription drugs. The small tenants in community shopping centers (for example, laundrettes, dry cleaners, shoe repair shops, and liquor stores) frequently need protection against direct competition from the department store cotenant.

Department store negotiators might demand a lease clause that allows the store to sell any catalog item from the store despite any limitations in the leases of other tenants. The landlord may have no option but to agree. However, the department store's right should be subordinate to restrictions against converting the store into a category killer, against carving out small stores as specialized stores, and against selling the core products of vulnerable small specialized stores.

Small Stores Operated by Major General Merchandise Chains

Landlords willing to sign a lease for a store that focuses on catalog sales tend to accept a use clause that permits the store to sell everything in the catalog. Nevertheless, here too, the landlord must be concerned that the catalog store tenant's right to sell catalog merchandise makes it possible for the tenant to convert the small general merchandise store to a completely different kind of store. Although large and medium-sized regionals can usually thrive despite a considerable amount of duplication, community or regional shopping centers may be harmed by such conversions.

An acceptable formula to resolve this issue should allow the store to carry catalog items as long as the items carried are not so concentrated that the store becomes a specialized store competing with another specialized store in the shopping center.

The Retail Outlets of Novelty Catalog Organizations

Wise landlords insist that the use clauses of novelty-type catalog stores specify the merchandise categories that the tenant will be permitted to sell and the merchandise categories that it is prohibited from selling. If the tenant agrees, it's likely to request the right to carry every item listed in the catalog.

A landlord who wants assurance that this right won't open the door to a drastic change of the store's character must prohibit the tenant from using this right to change the store's merchandise mix drastically or from changing the store's character in any other way.

Novelty catalog stores are most likely to find homes in regional shopping centers. Landlords of the bigger regionals tend to be relatively unburdened by exclusives, and they can afford to concede more liberal use clauses to the nov-

elty items. Although these attitudes can result in use clauses that effectively grant novelty catalog tenants freedom to change their character and merchandise mix, the large center is not likely to be harmed by a drastic change in one small store's merchandise mix. Nor is the change likely to cause trouble for any other tenant.

The same change in a small regional or community center can cause all sorts of damage. It can cause a conflict with another tenant's exclusive clause; it can also deprive the shopping center of a specialist in an important merchandise category and cause duplication of another.

Franchised Catalog Desks in Unrelated Retail Stores

A retail store that has a franchised arrangement with a third-party catalog company should request the specific right to display the catalog, to take orders to be filled by the franchisor, and to provide for customer pickup when the merchandise arrives. If the retail store is a specialized merchant and is limited by its use clause to a few merchandise categories, it needs additional rights to sell catalog merchandise that doesn't fall into one of the permitted merchandise categories.

A sophisticated landlord can accede to such a request as long as it doesn't cause a conflict with another tenant's lease. The tenant may then seek the right to stock catalog items at the store and sell them over the counter for contemporaneous pickup. That right can be misused to provide a back door method to facilitate a drastic change in the store's merchandise mix.

Even granting a tenant the right to take catalog orders and to provide pickup services may violate the exclusive clauses in the other tenants' leases. These tenants may argue that selling merchandise from a catalog in a store is still selling merchandise. A landlord can avoid this potential conflict only by negotiating for modifications in all other tenants' exclusive clauses to exempt the taking of catalog orders and providing pickup service.

The prudent landlord, therefore, looks ahead and provides for a catalog sales exemption from exclusives that apply to the sale of a product. Otherwise, that landlord might be forced to say "no" to a good tenant that takes on a catalog franchise. How bad is that? Probably not very bad, but why lose a dollar when you can earn one?

Instant Pickup Catalog Stores

Instant pickup catalog units cannot function without the right to sell catalog merchandise over the counter. The essence of their business is to sell catalog items at the store and to have the products immediately available for pickup. The risk of negotiating a lease with an instant pickup catalog store is that the store could abuse its right to sell from a catalog and change the character of the store. The circumstances under which such a change would be problematic have been discussed in detail above.

Upscale Specialty Catalog Stores

Many affluent consumers who never look at thick general merchandise catalogs are intrigued by specialized catalogs. The Sharper Image catalog, with its expensive gadgets and adult toys, seems to delight people with money to burn. J. Crew catalogs catch the eye with quality merchandise and even lure the viewer with very beautiful models. Upwardly mobile professionals welcome the chance to choose pricy tools in the Brookstone catalog.

Consumers visit upscale specialty catalog stores because of the aura that the catalog projects. Landlords should be careful that they do not give these specialized merchandise stores the power to transform their characters and images by introducing new and different lines in the catalog and repositioning the store. An example of a catalog store use clause that protects the landlord is given in the Appendix.

EXCLUDING OTHER CATALOG STORES

Occasionally, a catalog store asks for an exclusive clause that bars any other catalog store from the shopping center. Its motive may be merely to exclude direct competitors.

Landlords, however, should be aware that many different kinds of stores call themselves catalog stores. They should say no to broad clauses that could exclude entirely unrelated stores called catalog stores. If the prospective tenant's purpose is only to exclude direct competition, the landlord should be able to pro-

APPENDIX

Use Clause for Golden Bowl Catalog Store

1. The tenant shall use the premises as a Golden Bowl catalog store.
2. The store shall sell men's and women's clothing principally.
3. The store may also offer other merchandise listed in the Golden Bowl catalog from time to time subject to the following limitations:
 - i. The store may do so only as long as it is operated principally as a men's and women's clothing store.
 - ii. No category of merchandise listed in the table below shall be sold from the store. (Insert a table here that lists all exclusives set forth in existing leases in the shopping center.)
4. Notwithstanding anything to the contrary, no more than 30 percent of the store's displayed clothing shall consist of any of the following categories: large sizes, small sizes, maternity wear, action wear, sports team uniforms, foot wear, neck wear, or millinery.
5. The premises shall not be used for any other purpose. No other merchandise item may be sold from the store, and no other kinds of services may be rendered from the store.

pose an alternative that meets the tenant's specific need but does not exclude stores of a very different genre.

NOTES

1. When Gap, Inc. acquired Banana Republic, it tossed out almost everything except the name and started over. (Linda Himmelstein, Business Week, January 27, 1997, 72). This kind of drastic change in merchandise mix exemplifies the potential dangers that threaten landlords with lax use clauses. When retail executives are unhappy with sales or profits, they try something else. "Something else" may be profitable for the retailer but poison for a landlord who has already granted an exclusive for the "something else" to someone else.