REAL ESTATE REVIEW

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WEST GROUP

Use and Exclusive Clauses in Home Improvement Center Leases

A struggle for liberal use clauses and restrictive exclusive provisions

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ome improvement centers are creatures of the modern shopping center era. However, they can trace their roots to earlier but less sophisticated retail formats.

Many trends helped to promote their growth in the early 1970s, but home improvement centers owed their success primarily to the do-it-yourself movement. Odd as it may seem today, homeowners of the 1950s usually called the plumber when the toilet wouldn't flush and the electrician when the lights went out. They looked to contractors when they redid the kitchen, added a bedroom, or finished the basement. In the 1950s, homeowners who had the skills, time and patience to do the work themselves were the minority, and few retailers were attentive to their needs.

The do-it-yourself movement of the 1960s and 1970s fostered homeowners' confidence in their skills with tools and machines and increased the number of homeowners who had the courage to tackle home repairs and home improvements. Doing the work yourself was fun. It increased your self-esteem and, most important, it saved money.

Early retail beneficiaries of the trend included hardware stores, paint stores, electrical supply stores, plumbing supply stores, and garden supply stores. Among large general merchandise chains, none was better positioned to profit from this trend than Sears, Roebuck & Co. From its origin in the 1920s, Sears had targeted male customers. Sears merchandisers postulated that the most effective way to attract men to their well-stocked men's clothing departments was to carry hardware and related lines.

Before the advent of the home improvement center, most independent hardware stores were small. About 2000 square feet was a common size. Some merchants expanded their activities by adding housewares to their product mix. Combination hardware stores and lumber yards also competed for the trade. The combined units had more interior space than individual hardware stores and had an outdoor sales area for lumber sales. However, these combined units appealed more to building contractors than to homeowners.

In the early 1970s, shopping center customers, who had grown accustomed to 3,000-square-foot hardware stores and 2,000-square foot-paint stores, were dazzled by 20,000 to 40,000 square foot units dedicated to hardware, lumber, paint, electrical equipment, lighting fixtures, and plumbing equipment. Shortly thereafter, they were overwhelmed by a Rickel Brothers Home Improvement

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Center with about 100,000 square feet of gross leasable area that offered seemingly infinite varieties of hardware, electrical supplies, plumbing supplies, lighting fixtures, paint, and probably the world's greatest toilet bowl collection.

OPTIMUM STORE SIZE AND LOCATION

Debates about the optimum size for home improvement centers started immediately. Public reaction to the monstrous Rickel Brother's early units disappointed its owners when early sales volume was weaker than anticipated. Other early competitors like New York and New Jersey's Channel Lumber and Southern California's Builder's Emporium experimented successfully with much smaller units. For a while, their stores ran about 30,000 square foot with modest outdoor sales areas.

Home improvement center site locators of the early years sought mature markets. They looked for locations in existing established shopping centers. However, even in the 1970s, it wasn't easy to find an established shopping center in a mature market that had enough additional land to permit the landlord to build a new home improvement center. Thus, the prospective tenants often had no choice but to lease existing buildings.

Fortunately, the emergence of home improvement centers coincided with drastic changes in the food supermarket business. Older and smaller supermarkets couldn't compete with newer and larger units. Because expanding an existing supermarket's space tended to be impractical, managements usually closed undersized supermarkets and moved to entirely new buildings. Thus, closed supermarkets with less with less than 30,000 square feet of gross leasable area became an abundant source of new home improvement center locations.

As the retail business improved in the euphoric 1980s and home improvement centers faced fewer opportunities for existing building conversions, their expansion emphasis shifted to build-to-suit deals, and the debate about ideal store size intensified. In 1984, Lowe's Cos., then the industry leader, began to build new stores that ranged from 25,000 square feet to 54,000 square feet plus outdoor sales areas. Later, it opted for larger stores, and in 1990, Lowe's opened a 100,000 square foot store.[1] The average store size of current industry leader, Home Depot, was reported in 1991 to be 100,000 square feet of gross leasable area.

HOME IMPROVEMENT CENTER USE CLAUSES

Home improvement center pioneers with stores of about 20,000 to 50,000 square feet knew that they had to protect themselves against the possibility that they might be making commitments to pay rent for space that they couldn't use profitably for the entire lease term. They worried that their new existing home improvement center business might be just a temporary fad.

Market conditions compelled home improvement store executives to sign long-term leases to get the space they wanted in attractive locations, and they knew they would have to meet these rent commitments even if their core business waned. They knew they could not commit themselves to sell nothing but hardware, lumber, and their other current merchandise categories for the next fifteen, twenty or twenty-five years. From the very beginning, one early home improvement center chain planned to add sporting goods and sports clothing to its core product lines and to add general merchandise departments to fill the balance of the space. For these reasons, home improvement center lease negotiators requested the same kind of use clause that department stores demanded and got routinely. They insisted on the right to use the premises for *any legal purpose*.

Of course, such a broad use clause can create potential problems for the landlord. It opens the door to the danger that a building seemingly dedicated to use as a home improvement center might suddenly become a food supermarket, toy super store, or record super store. It also opens the door to the possibility that the store might even be carved up into a group of small stores. Prudent landlords attempted to prevent potential drastic changes in the store's use.

One way landlords tried to set boundaries on the home improvement center appetites for encroaching on other specialized merchants' territory was to propose that these tenants agree to use the premises as a *home improvement center*, but the tenants couldn't live with the restriction. The home improvement business was just starting out and had not yet defined itself. Moreover, some home improvement chains were controlled by supermarket and department store chains. In these circumstances, corporate headquarters might decide not to keep home improvement operations separate from their other businesses.

Some landlords allowed home improvement center tenants to use the demised premises for any legal purpose except for a list of specifically prohibited activities. Here are some of the compromises I saw after arduous negotiations between landlords and early home improvement center tenants.

Provisional definitions. Some tenants agreed to start business as home improvement centers, but they insisted on the right to make changes later. They refused to establish a definition of home improvement center that would be valid for the entire lease term. They argued that no one had long-term experience in the home improvement center business. Who knew how would it evolve, what product lines would be added or deleted? On the other hand, these tenants were willing to open for business as a home improvement center and define home improvement center for that purpose. They could define the product mix of the home improvement center they planned to open imminently as a store with the product mix of their existing stores, possibly modified for the new location.

Selective forbidden uses. Home improvement center tenants who wouldn't agree to any other restriction might nevertheless agree that the store would not be converted to (say) a food supermarket or drugstore. They were usually also willing to accept restrictions against the sale of food for off-premises consumption or the employment of a registered pharmacist.

Prohibitions against carveouts. Strong landlords could obtain a restriction against carving small stores out of the large home improvement center premises. Tenants could also agree to use the premises as a single retail entity, to refrain from partitioning parts of the store, and to refrain from providing separate entrances and exits between the partitioned rooms and the common area.

Prohibitions against violating existing exclusives. Because landlords were adamant, the early home improvement center tenants agreed not to convert stores to uses that would violate the restrictive covenants in other tenants' leases.

HOME IMPROVEMENT CENTER EXCLUSIVE CLAUSES

Home improvement center operators' struggles for liberal use clauses did not make them liberal free trade advocates. Their efforts to stop landlords from limiting their use rights didn't alter their determination to impose restrictions on other tenants. Their most important goal was to exclude any other home improvement center from the shopping center. Lease negotiators must surmount two big barriers to make an exclusive clause meaningful:

- They must define what a home improvement center is and
- They must cope with the possibility that another tenant with the right to use its premises for any legal purpose will decide to become something like a home improvement center.

Defining A Home Improvement Center

It's not easy to define a home improvement center. Stores with less than 20,000 square feet and as much as 100,000 square feet of gross leasable area have all been called home improvement centers. No matter what they are called, stores at these two extremes are vastly different from each other. They differ in both the scope of their merchandise mix and the depth of their merchandise offerings.

Nevertheless, the differences among home improvement centers are outweighed by their similarities. The following three common attributessimilarities offer a guideline for formulating a definition:

- Home improvement centers are relatively large stores. A 3,000-square-foot hardware store, paint store, lighting fixture store, electrical supply store, or garden center is not a home improvement center.
- Home improvement centers are specialized stores. A home improvement center is not a general merchandise store. A department store with a big hardware department is not a home improvement center. It's a department store as long as it carries an extensive line of items like clothing, jewelry, luggage, handbags, and cosmetics in depth.
- Home improvement centers combine specified specialized departments. Home improvement centers have hardware departments. A store without a hardware department is not a home improvement center. Typical home

improvement center departments also include lumber, garden equipment and supplies, electrical and plumbing fixtures and supplies, and lighting fixtures and, frequently, housewares and carpeting.

Protection From Competition

If the parties can agree on a definition of *home improvement center*, they should be able to agree on a restriction that protects the tenant from competing home improvement centers but does not conflict with existing leases or those that the landlord may negotiate in the future.

Before a landlord agrees with a home improvement center tenant that no other home improvement center will be in the shopping center, it should review existing leases to make sure that none of the leases allow the tenant to use the premises for *any legal purpose* or permit the tenant to change its use to other legal uses or enable other tenants to compete with the home improvement center.

Home improvement center negotiators often propose restrictions against other tenants' sales of core products like hardware, lumber, electrical supplies and fixtures, lighting fixtures, plumbing supplies and fixtures, bathroom fixtures and improvements, and kitchen improvements. Landlords must treat these proposals carefully and respectfully. Home improvement centers pay a lot of rent and draw many people to a shopping center, but landlords should not agree to these product restrictions unless the lease also lists the kinds of stores that will be exempt from the restriction. Home improvement center operators expect to compete with department stores, and they are usually willing to tolerate variety store and other general merchandise store competition. They tend not to worry about supermarkets and drugstores selling a handful of hardware items.

Landlords should also strive to protect the rights of small store tenants. A merchant conducting a home improvement center business from a cavernous 100,000-square-foot storeroom need not be concerned about competition from a 3,000-square-foot hardware store, paint store, or lighting center.

EFFECTS ON USE AND EXCLUSIVE CLAUSES RESULTING FROM THE MANNER IN WHICH TENANT ACQUIRES ITS LEASEHOLD ESTATE

Early home improvement center operators acquired leasehold estates in existing buildings in the following four ways:

- By negotiating a new lease with the landlord;
- By negotiating with a tenant for an assignment or sublease;
- By negotiating with both landlord and tenant for space subject to an existing lease; or
- By acquiring a leasehold in Bankruptcy Court proceedings.

A New Lease with the Landlord

When in the 1970s, home improvement center tenants negotiated with landlords for previously occupied buildings, they found that the buildings had been used as supermarkets, variety stores or small discount department stores and that repairs and alterations were required to convert dingy, old-fashioned general merchandise or food stores to contemporary and attractive home improvement centers.

Landlords asked for market-rate rents that would reflect the carrying charges allocable to the premises plus a reasonable return on any new cash that they invested in the renovation.

These circumstances gave landlords a good deal of control over the use and exclusive clauses. If they didn't like the tenant's proposals for use and exclusive clauses, they could offer alternatives, and if they weren't satisfied with the ensuing compromises, the landlord could break the deal. They could assure themselves that the new tenant's use clause prevented it from violating existing tenants' exclusive clauses. They could also establish appropriate boundaries for the tenant's exclusive clause.

An Assignment or Sublease from an Existing Tenant

If the building was occupied, the home improvement center operator could approach its tenant, seeking assignment or sublease of the existing lease. If the exiting tenant had carefully negotiated its lease, the home improvement center operator might have been able to make a deal at a low cost without confronting the landlord at all, either by purchasing the leasehold estate or by subletting the premises from the existing tenant. The transaction was possible only if 1) the

assignment clause in the existing lease permitted the tenant to assign it without the landlord's consent; 2) the alterations clause permitted significant changes to the building; and 3) the use clause permitted conversion to another kind of store. Otherwise, the deal depended on the landlord's cooperation. Of course, the home improvement center tenant was stuck with the existing tenant's assignment, alterations and use clause for better or for worse.

Negotiating with Both Landlord and Tenant

If the original tenant had not negotiated its lease carefully, the home improvement center operator was forced to embark on a complex series of negotiations.

First, it made a deal with the existing tenant. Then the parties sought approval from the landlord. The visit to the landlord often proved to be expensive. The landlord usually wanted more rent, a shorter term, or other changes to the existing leases as the price for its cooperation. Usually it also wanted changes in the use and exclusive clauses.

Acquiring a Leasehold in Bankruptcy Court Proceedings

The home improvement centers' emergence and early success coincided with a severe downturn in the fortunes of some variety and discount department store chains. Value-oriented general merchants were particularly hard hit in the mid 1970s. One after another filed for Bankruptcy Court protection.

Tenants that had filed for protection sought to raise cash by selling their leasehold estates. Although they were willing, even anxious, to negotiate leasehold sales, they needed Bankruptcy Court approval to consummate the deals. The Bankruptcy Courts usually insisted that they allow other prospective buyers to offer a better deal. In brief, a negotiation with a Bankruptcy Court-protected debtor was merely the prelude to an auction. Each transaction with a tenant that had filed for protection by the Bankruptcy Court was an adventure.

The W. T. Grant proceedings were among the most spectacular of these adventures. The hapless firm sold more than 1,000 leasehold estates to bidders in a crowded and uncomfortable courtroom.

Grant's stores came in many different sizes. Home improvement center organizations were among the most active bidders for smaller and medium-sized units. They competed for the smaller units with supermarket and variety store chains. They competed with discount department stores for the larger units. Landlords bid also, certain that if they could purchase a leasehold, they could enter into a new lease at higher rents.

All the bidders assumed that most of Grant's store locations were very good, and that the poor sales volume numbers were principally due to management problems. Although the bidders had to squeeze into the courtroom, they didn't squeeze their wallets. The leaseholds were relatively inexpensive, and the rental rates were cheap.

What about use and exclusive clauses for the leases acquired in the Bankruptcy Court proceedings? Successful bidders acquired W. T. Grant use and exclusive clauses, which were usually quite liberal from the tenant's point of view and were burdened by few limitations on the tenant's merchandise mix. Grant's standard use clause did not prohibit the leaseholder from opening a home improvement center.

Subsequent retail bankruptcy proceedings (in particular, the Food Fair Stores' proceedings) provided bidders with less of a bonanza. As retail conditions improved, bidders became more aggressive. They bid higher and paid more. Nevertheless, home improvement center chains sent delegations to bid, and some of them acquired still more locations in that way.

Having proved that they serve essential consumer needs and that they can do so profitably, home improvement centers are now commonplace elements of the retail landscape. Despite early site location problems, their ambition to squeeze into established markets has been achieved. Some home improvement centers are anchor tenants of community-type or neighborhood shopping centers. In all cases, both landlords and tenants must pay careful attention to the use and exclusive clauses. They have nothing to lose but money.

NOTES

1.Seth Lubove, "A Chain's Weak Links", Forbes, January 21, 1991, p. 76