10 Key Lease Points Every Restaurateur Needs to Know

Presented by:

Illinois Restaurant Association, Fox Swibel, Levin & Carroll LLP, and the Cook County Small Business Source

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Cook County SMALL BUSINESS SOURCE
Providing Access, Fostering Growth

The Cook County Small Business Source strives to support, grow and elevate small businesses by providing no-cost **business advising**, **resources** and access to **events**.

This program directly connects small business owners with expert guidance and support to take businesses to the next level.

Cook County established the award-winning program to ensure that businesses emerge from COVID-19 intact and positioned for growth.

Impact

10,000+

Small businesses reached

$17Mill

In grants distributed to businesses with 20 employees or less

2,700+

Businesses supported through direct assistance

66%
businesses owned by people of color

55%
businesses owned by women

76%
microbusinesses (with 5 or less employees)



Overview of Services



Business Advising

One-on-one, expert business advising provides small business owners with the advice and assistance they need.



Resources

A resource library and a network of over 30 partners are available to help grow and scale small businesses.



Events

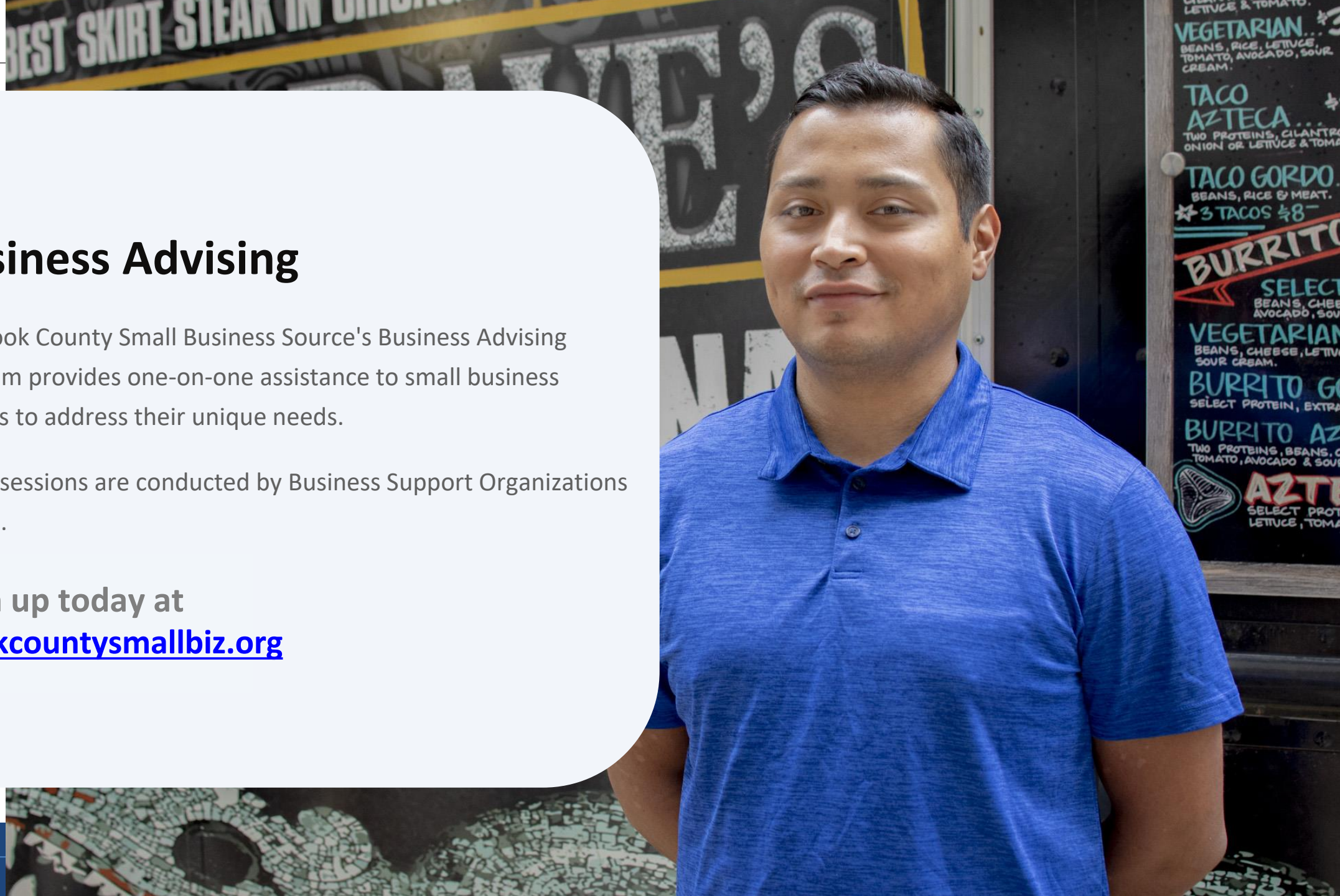
Events connect small business owners with a community of advisors who provide in depth knowledge on topics important to small businesses.

Business Advising

The Cook County Small Business Source's Business Advising program provides one-on-one assistance to small business owners to address their unique needs.

These sessions are conducted by Business Support Organizations (BSOs).

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10 Key Lease Points Every Restaurateur Should Know

Lawrence Swibel and Scott Schonfeld

Fox Swibel Levin & Carroll LLP, Chicago





Overview

1. Use of a Corporate Entity
2. Rent Commencement Date
3. Percentage Rent Issues
4. Intellectual Property
5. Force Majeure / Pandemic Relief
6. Tenant Exclusives
7. Assignment / Transfers of Lease
8. Subordination and Non-Disturbance
9. Market Rent during Extension Periods
10. Tenant Improvement Allowances

Attorney-Client Privileged

1. Use of a Corporate Entity

- If you sign a lease in your personal capacity (*e.g.* "Scott Schonfeld, as Tenant"), then you have unlimited liability.
- ***But***, if you use a separate entity (*e.g.*, a LLC, limited partnership, S-corp) to enter into a lease (an **"OpCo LLC"**), then all liability relating to that lease is limited to the assets of the OpCo LLC.
- **Why that matters**: If the only assets the OpCo LLC has are its interest as tenant under the lease, equipment, inventory, and other contractual rights, you, as the beneficial owner of OpCo LLC have greatly reduced your potential liability.
- OpCo LLC should not only enter into the lease, but all vendor, supplier, and employment contracts as well.

- ***But*, you're probably asking -- what about guaranties? It's true. Most landlords will still require some form of guaranty. They will typically ask for both a "payment" and "performance" guaranty. What options do you have?**
  - **Negotiate a "cap" – whether on time the guaranty continues, total dollar exposure, or both. (*E.g.*, Guarantor's liability shall in no event exceed $200,000, or that the guaranty shall burn off within three (3) years following the opening of the restaurant.)**
  - **Consider using a corporate guarantor as opposed to a personal guarantor.**
  - **Make sure you have a lawyer carefully review and negotiate the cap language.**

- **BEST PRACTICE: Create a new single purpose entity LLC, and negotiate limitations on the guaranty.**

2. Rent Commencement Date

- A "Rent Commencement Date" ("**RCD**") is the date on which rent under the lease commences.
- Often, landlords will push for the RCD to be a "hard" date following execution (*e.g.*, 180 days after lease execution).
- ***But***, tying the RCD to a "*hard*" date is risky. Why?
  - **Landlord's Work**: What if Landlord doesn't complete the "Landlord's Work" (e.g., delivery of a warm vanilla shell) by a certain date? And, what if "Tenant's Work" is practically conditioned upon the prior performance of Landlord's Work? Tenant shouldn't be penalized because Landlord delayed.
  - **Permits:** What if, despite best efforts, the City of Chicago won't issue you requisite permits (*e.g.*, a building permit)?
  - **Force Majeure**: What if you ordered a special type of wood for the restaurant's bar but it can't be delivered in a timely fashion?

- **BEST PRACTICE: Make sure that the RCD is a set period of time *following* the fulfillment of each of (i) Landlord's Work and (ii) receipt of Permits. We also subject the RCD expressly to day-for-day extension on account of "Force Majeure Events".**

3. Percentage Rent Issues

- Leases often provide for the payment of "Percentage Rent" (*i.e.*, a percent of the restaurant's "Gross Sales") in addition to "Base Rent".
- There are **three** (3) key points to focus on when negotiating Percentage Rent.
- **Issue One:** The Definition of "**Gross Sales**"
  - Usually, a Lease defines "Gross Sales" as a variation upon the following language: "**all** revenues from sales resulting from all business conducted upon or from the Restaurant, whether evidenced by check, cash, credit, charge account, exchange or otherwise, and shall include (without limitation) the amounts received from the sale of goods, wares and merchandise, including sales of food, beverages and tangible property of every kind and nature, promotional or otherwise (excluding restaurant equipment) and for services performed from or at the Restaurant, whether the tenant fills the orders from the Restaurant or elsewhere."

3. Percentage Rent Issues (Cont'd)

- ***But***, "Gross Sales" should *exclude* items that you don't make money on. Below is a **non-exhaustive** list of items that should be carved out:
  - Credit Card Fees
  - Gift card sales (until the same are redeemed, in which event such sales should count as Gross Sales)
  - Charitable donations
  - Employee Tips
  - Gratuities ("comps") to customers
  - Delivery Fees (DoorDash, GrubHub, Postmark, etc.)
  - Off-site catering revenues
  - Returns/Exchanges
  - Sales Taxes
  - Sales of goods not in the ordinary course
  - Catering and/or off-site sales

3. Percentage Rent Issues (Cont'd)

- **Issue Two**: ***When*** **do you pay Percentage Rent?**
  - Leases often provide for *monthly* payment of percentage rent based upon an annualized projection of Gross Sales.
  - ***E.g.:*** Tenant pays, on a monthly basis following the RCD, 5% of Gross Sales over a breakpoint of $5 million.
    - ***Assume the Tenant generates $500,000 in gross sales in the first month. Landlord would be entitled to $4,166.67 that month.***
  - ***But***, what if that month is an outlier, and ultimately Tenant doesn't generate $5M in Gross Revenue on an ***annual*** basis?
  - That's why Percentage Rent should always be paid on an ***annual*** basis, ***if and when*** Gross Sales satisfying the percentage rent threshold have been met.

- **BEST PRACTICE: Make sure that the definition of "Gross Sales" contains any appropriate exclusions, and make sure that you are paying Percentage Rent on an annualized basis based upon actual sales rather than projected sales.**

Issue Three: **Percentage Rent Breakpoints**
Leases can provide for a "natural breakpoint" or an "artificial breakpoint".

A natural breakpoint is where gross sales equal the annual minimum base rent divided by the agreed-upon percentage.

An artificial breakpoint is an arbitrary percentage of gross sales over a specified sales amount (i.e. 5% of gross sales above $5,000,000).

Often times, leases may provide for both an artificial breakpoint and a natural breakpoint. *E.g.,* 5% of sales above a natural breakpoint, but if sales reach $10,000,000 in any lease year, then 3% above such amount.

BEST PRACTICE: make sure you have carefully negotiated the breakpoints with the right percentage of gross sales.

Natural Break Point Example

Annual Minimum Base Rent	**$200,000**
Agreed-Upon Percentage	→ **5%**
Natural Breakpoint	→ **($200,000 / 5%) = $4,000,000.00**

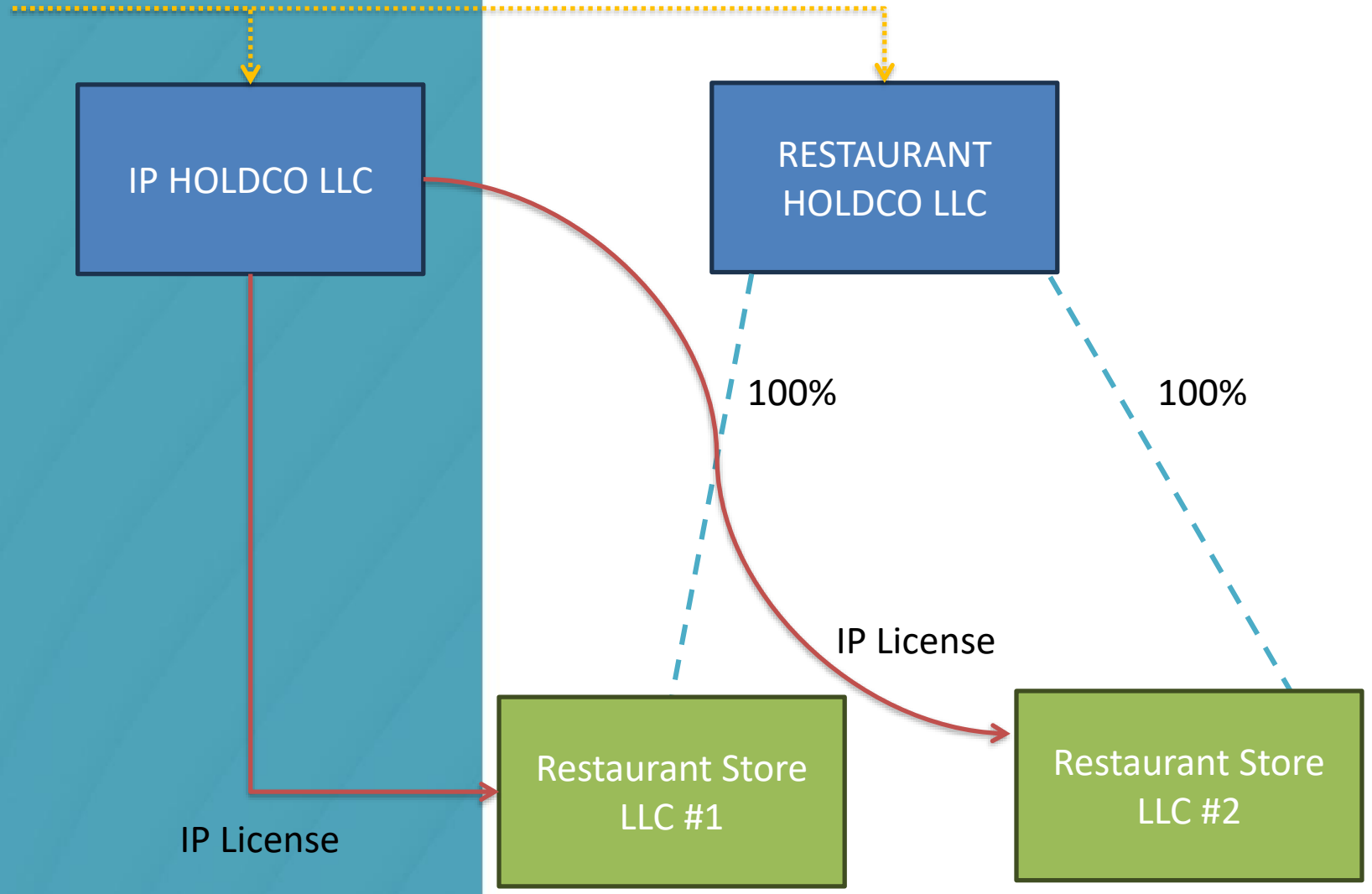
4. Intellectual Property

- The single most valuable asset a restaurant possesses is its intellectual property – the restaurant's trademark as well as the *restaurant concept*, that is the "look, feel, menu design, service style, and cuisine" which distinguishes one restaurant from another.
- *So*, if the IP is the company's single most valuable asset, who should own it?
- Unsavvy restaurateurs will provide in each of their operating agreements "all intellectual property of the Company . . . is owned by the LLC"
- ***But,*** what if you have more than one store operating under a concept?
  - Who owns the IP then? All of them? None of them?
  - If you have investors in a particular restaurant, what ownership do they have?
  - What happens when you sell one restaurant LLC – have you sold the IP?



Solution: Use an IP HoldCo

Owners of IP HoldCo and Restaurant HoldCo LLC:
Larry Swibel (50%)
Scott Schonfeld (50%)



5. Force Majeure / Pandemic Relief

- In the wake of COVID-19, an extremely important issue is what happens when there are so-called "Force Majeure Events".
- A typical force majeure provision in a Lease might read as follows:

20. **FORCE MAJEURE.** *If either party shall be delayed or prevented from the performance of any provision of this Lease by reason of strikes, lockouts, labor troubles, inability to procure material, failure of power, restrictive governmental laws or regulations, riots, insurrection, war or other reason of a like nature not the fault of the party delayed in performing work under the terms of this Lease, the performance, unless otherwise provided herein, shall be excused for the period of the delay and the period for performance shall be extended for a period equivalent to the period of the delay; provided that the party so delayed shall notify the other party within five (5) days after the onset of the event causing delay.* ***It is understood, however, that this provision shall not operate to excuse Tenant from the prompt payment of rent or any other payments required by this Lease. It is also understood that a party's financial ability to perform shall not be deemed to excuse nonperformance or delayed performance****.*

5. Force Majeure (Cont'd)

- ***But***, these clauses were not particularly helpful during a prolonged pandemic. Most clauses, like the example we provided, expressly exclude rent relief.
- The "parade of horribles" is a situation in which a restaurant tenant cannot perform, but is nevertheless forced to pay rent.
- That situation is ***exacerbated*** when there is a guaranty in place. If there wasn't a guaranty, you might reasonably simply "walk away" from the entity. That is not possible with a guaranty.
- **SOLUTION**: Address "pandemic relief" head on in lease negotiations. In 2024, we have found that Landlords anticipate the issue, and will, despite their protest otherwise, accommodate some form of rent (or other pandemic relief) in about 50% of cases. This is a highly negotiated issue, and one which needs to be tailored for the market in which you are operating (Chicago vs. Texas).

5. Some Pandemic Relief Options

- **Option #1**: Rent abatement and/or deferment – Landlords will either forgive or defer rent for some period of time.
  - A typical Landlord package will be 6 months of deferred rent, payable over a period of one year once Tenant has re-opened the store.
  - **This solution is better than nothing, but puts significant financial pressure on the restaurant once it has reopened.**
  - **Restaurateurs should push strongly for abatement (i.e. rent forgiveness) over rent deferment.**
- **Option #2**: Termination option – Landlord will indicate that if an event of Force Majeure has precluded Tenant from operating for xxxxx months, Tenant may, upon written notice, terminate the Lease.
  - **Particularly if there is a guarantor in place, a termination open can reduce a considerable amount of exposure.**
  - **Termination options also incentivize landlords to renegotiate rent if there is a real threat that a tenant will terminate the Lease.**
- **Option #3**: Rent Abatement and Percentage Rent as a substitute for Minimum Rent if Tenant is not able to operate at full occupancy.
  - Typical language would provide that if there is an event of Force Majeure which precludes Tenant's occupancy of more than 50% of the Premises for thirty (30) consecutive days or more, then, in the event that Tenant elects to operate at all, Tenant shall pay ten percent (10%) of its Gross Sales in lieu of all Minimum Rent which would otherwise be due.
  - **This solution is the most tenant-friendly, and provides tenants a safety valve when they cannot operate at full capacity.**
  - **Landlords are hesitant to give this type of relief, but may accept it subject to a "sunset" (i.e., the relief either expires after some period of time, or Landlord can terminate the lease after a certain period of time)**

6. Tenant Exclusives

- If you're a restaurant in a shopping center, or a restaurant in a large strip center, give some thought about asking for an exclusive.
- **Hypothetical**: You're a "chicken concept" which specializes in chicken fingers and chicken sandwiches, and Landlord offers you an exclusive for a store "whose primary business is the sale of chicken-related menu options." **What does that language mean?**
  - Does that mean you have an exclusive on the sale of chicken?
  - Does that mean you exclusively are able to offer a menu which is comprised primarily of chicken options?
  - **Answer**: It's vague at best, and, without spelling out exactly what your exclusive protects, you may have just bought yourself nothing more than a dispute down the road.

6. Tenant Exclusives (Cont'd)

- **SOLUTION #1: Operationalize the exclusive by percentage of menu options**
  - "Landlord acknowledges and agrees no other tenant at the Shopping Center may have a menu, more than 50% of which is comprised of chicken-related options."
  - **Problem**: What if the chicken sandwich drives 40% of the tenant's gross sales?

- **SOLUTION #2: Operationalize the exclusive by percentage of gross sales.**
  - **"**Landlord acknowledges and agrees no other tenant at the Shopping Center may generate more than [40%] of its gross revenues from the sale of chicken-related menu offerings."

7. Assignment / Transfers of Lease

- Ordinarily, Leases may not be "assigned" or "transferred" without Landlord's consent.
- Tenants should carve out assignments to "Permitted Transferees", which should include:
  - Affiliates controlled by or under common control as Tenant
  - Entities which result from merger with Tenant and/or restructuring of Tenant
- **HYPOTHETICAL**: Imagine you are the owner a 7-store chicken sandwich concept, and you have a purchaser who wants to buy the entire chain of restaurants (a **"Company Sale"**). Without language expressly addressing a right to transfer the Lease in connection with a Company Sale, it would be subject to one landlord's consent.

7. Assignment / Transfers of Lease (Cont'd)

- **SOLUTION:** Address the issue of a "third party purchaser" head on.
  - ***E.g.,*** "Notwithstanding the foregoing, Tenant may assign this Lease in connection with the sale of at least three (3) stores operating under the same concept."
- **Landlord push back**:
  - " . . . at least three (3) stores operating under the same concept, *so long as such third party purchaser is (i) a first-class quality operator of similar restaurants and (ii) has a net worth no less than Tenant's measured as of the moment immediately prior to such transfer.*"
  - ***Be very careful to allow subjective standards like "first class quality operator" or "similar stores" to undo the objectivity of the transfer right.***
  - ***Consider specifying a dollar value net worth rather than subjecting the transfer to a measurement test.***

8. Subordination and Non-Disturbance

- Often, Leases will provide that tenants leases will be subject and subordinate to any senior lien securing the property.
- If the lease is executed subsequent to the owner's senior loan, then, in the event the owner defaults, the lender can elect to terminate the Lease.
  - Many leases will provide that Landlord shall use commercially reasonable efforts to obtain a SNDA, but that isn't good enough, because if Tenant does not obtain a SNDA, Tenant won't have protection.
  - Often times, Landlords will accept conditioning execution of the Lease upon receipt of a SNDA so long as Tenant indicates it will accept lender's standard form of SNDA.
- But, Lender's standard form of SNDA is typically very lender-friendly. Nevertheless, it's better than nothing.
- This is why it's so important to have a subordination, non-disturbance and attornment agreement ("SNDA") in place.

9. Market Rent during Extension Periods

- During an extension period, the lease may provide that the rent payable during an extension period will be fair market value ("FMV").
- ***But,*** how is FMV determined?
  - Landlord's reasonable determination?
  - "Baseball arbitration"?
- Beware of hidden FMV mechanisms which appear to be objective but which are essentially controlled by Landlord, including the use of artificial "FMV floors"
- Consider negotiating a specified rent amount during an extension period (i.e. 2.5% annual escalation)
- Why?
  - If you negotiate extension period rents which are below market, then you will have the benefit of a below market lease.
  - If it turns out that your extension period rent is above market, you can simply elect not to extend the lease and you could still negotiate a market rent with Landlord separately.
  - You should negotiate that Extension Options should not be personal only to tenant but also extend to Permitted Transferees.

10. Tenant Improvement Allowances

- There are four (4) main issues to address when negotiating disbursement of TI Allowances:
  - How is it disbursed?
    - Once the restaurant is opened?
    - In tranches (if so, monthly, as a percentage of completion?)
    - Who determines percentage of completion? Landlord? Landlord's architect? Mutually agreed?
    - Can you apply both "soft" and "hard" costs towards the TI?
      i. Are the soft costs capped? 10% of TI? 20%?
  - Does it go away?
    - 12 months after execution?
    - 2 years?
  - What is required to get it?
    - Landlord should only condition disbursement upon partial (and final, as appliable) lien waivers for work performed
    - Consider carving out de minimis amounts (e.g., invoices greater than $5,000)

Questions?

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