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One Minute Memo®

Mini-Mall Conversions Within Department Stores

Introduction

One increasingly common trend among retailers, which either have excess space in existing locations or which wish to cease operations altogether, is the development of "mini-malls" or stores-within-stores. Retailers have looked to the establishment of in-store shops as a means of offering new product categories, attracting new consumers, and defraying leasing costs in an uncertain economy. While this practice is most prominent among clothing retailers, the store-within-a-store approach has been adopted industry-wide and many analysts see the trend accelerating in the future.

As this approach becomes more common, retailers, their landlords, and prospective subtenants need to be mindful of the legal ramifications that these subtenancies or licensing agreements pose and must, accordingly, structure their leases to avoid potential pitfalls. This article highlights both the potential risks implied by mini-mall arrangements and offers practical legal recommendations to avoid or mitigate those risks.

Avoiding Co-Tenancy Clause Issues

One issue of great concern to landlords is the potential of violating co-tenancy provisions with other mall tenants. Indeed, mini-malls are most commonly created within the premises of anchor tenants, and other, smaller tenants (or other department stores, for that matter) often condition their lease or rental obligations on the continued presence and/or operation of a specified number of anchor tenants. A typical lease might provide that a tenant will not be obligated to keep open or keep operating its store at full rent unless one or more anchor tenants are also operating. Mini-malls create complications insofar as mini-malls often contemplate either (i) the absence or abatement of operation of an anchor tenant or (ii) the replacement of the anchor tenant with an impermissibly large number of smaller, "replacement" tenants.

To avoid this result, a landlord must address this situation on two fronts. First, the landlord needs to restrict an anchor tenant's ability to assign or sublet. Since most anchor tenants will insist on some flexibility with regard to such "transfers", one possible compromise would be to allow the anchor to assign to another national single-occupant retailer, or to sublease to not more than two other operators -- provided in either case, there are no new entrances or signs erected, and the store continues to have the appearance of a single operator. These restrictions would not, however, limit the presence of licensing arrangements between the original tenant and one or more licensees. Licenses provide tenants greater control over the premises while simultaneously allowing for a revenue stream substantially similar to that received under a sublease. While most leases expressly disallow subleases or assignments, they may be silent as to licensing arrangements; thus, licenses can represent an opportunity to effectively repurpose real estate where otherwise forbidden. Landlords should be careful to provide for the same restrictions on these licenses as they would include in assignments and subleases.

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Second, a landlord must also take care in drafting the co-tenancy language in the leases of the other tenants in a center so that the landlord is not adversely impacted if another tenant vacates. From the landlord's perspective, the loss of one anchor should never trigger a landlord default. As a practical matter, a lease should never specifically identify a particular anchor as a requirement for another tenant's continued lease obligations; rather anchor tenants should only be described with generality (e.g., a national clothing retailer occupying 10,000 sq. ft.) From the tenant's perspective, a replacement tenant (or multiple tenants) should be permitted in the event that an anchor ceases to operate, but only so long as the total occupied square footage is at least seventy-five percent (75%) of the original space. Other tenants may require a larger total occupied percentage and also may require that if multiple operators have replaced the anchor tenant, at least one of the replacement tenants is a national (or regional) tenant occupying at least fifty percent (50%) of the original space (so as to avoid the complete break-up of the original space into the mini-mall scenario discussed above.)

Mini-malls are an increasingly common and, thus, significant development in commercial real estate. However, because these arrangements pose substantial anti-assignment and co-tenancy clause concerns, care must be exercised in the drafting of leases, not only with so-called "anchor" tenants but also with the other tenants in a shopping center. Clients drafting leases which contain co-tenancy provisions should contact their Seyfarth Shaw LLP Real Estate professional to review and revise their leases in order to avoid or mitigate such concerns.

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