Shedding Light when
Anchor Tenants Go Dark

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Retail tenants come and go, but what happens when the anchor tenant in a shopping center goes dark and maintains a possessory interest in the empty store. There are many reasons why a retail tenant may vacate. Sales are down and it is more profitable to close the store. The retailer has opened another branch nearby, but in a better location. Perhaps the demographics have changed for the worse and store renovation is not a prudent investment. This problem is often faced by shopping center owners in mature economic markets.

Why would a retail tenant keep the lease in place, but not negotiate a termination, assignment or sublease? Often, the cost of keeping the competition away is worth the effort. Maintaining a possessory interest keeps competitive retailers from occupying and getting a foothold in the market. This raises a number of challenges for the shopping center owner. First, the closure can have a negative impact and diminish sales for all retailers in the center. Second, the closure decreases the income stream and hence the value of the center. In short, everyone suffers but the vacating anchor.

The most troubling issue for landlord is the loss of percentage rent. Since the store is closed, there is no percentage rent, but the lease remains active. This article will examine the legal grounds for asserting full payment of percentage rent after store closure, as well as legal exposure resulting from such a closure.

**Tenant’s Duty to Operate during the Leasehold**

Many shopping center leases contain an operating covenant obligating the lessee to operate continuously and keep its business open for certain specified hours during weekdays, weekends, certain holidays or other specially designated days. The mutual success of the tenants and landlord require that stores within the center remain operating. A shopping center is much more attractive to customers when it provides the maximum number and range of retail shops, bustling with a healthy and thriving appearance. The landlord benefits from imposing high standards which maximize the percentage rent derived from the tenants. The tenants mutually benefit from the higher cross traffic resulting from the landlord’s imposed operating requirements.

While modern landlord shopping center leases require the tenant to continuously operate its business from the premises, excluding limited periods of time for remodeling or casualty repair, the lease language in older retail lease forms is not so clear.
Implied Covenant to Operate

Can a shopping center landlord require a lessee to continue to operate, absent an express operating covenant? Generally, the answer is no. Implied covenants in leases are disfavored. Rothe v. Refco D.S., Inc., 148 F.3d 672 (7th Cir. 1998). Although some courts have found tenants subject to an implied covenant to operate continuously in certain circumstances, many courts have refused to enforce an implied covenant to operate continuously. Scot Properties, Ltd. v. Wal-Mart Stores, Inc., 138 F.3d 571 (5th Cir. 1998).

Yet many courts have found an implied covenant to operate under a business "output" theory of contracts. “From the business situation, from the conduct of the parties, and from the startling disproportionate burden otherwise cast upon one of them, a promise is implied in fact by the seller to continue in good faith production or sales, or on the part of the buyer to maintain his business or plant as a going concern and to take its bona fide requirements. In other words, this view implies an obligation to carry out the contract in the way anticipated, and not for purposes of speculation to the injury of the other party ....” (1 Williston on Contracts, § 104A, pp. 357-358.) Where the rental for use of a building is based upon a percentage of sales, the lessee reasonably may be said to covenant impliedly that he will use good faith to insure a continuation of them.

Each lease and rental agreement also includes an implied covenant of good faith and fair dealing. Courts will enforce contractual provisions which are clearly within the contemplation of the parties even though not expressed, and the promise would have been made if attention had been called to it. However, there can be no implied contract where the subject is completely covered by the contract.

Implied Covenant to Operate

Where a tenant pays percentage rents, courts have found an implied covenant by the tenant to operate its business when the minimum rent is considered insubstantial and would not provide the landlord with a reasonable rate of return on its investment in the premises given the circumstances of the lease, Lippman v Sears, Roebuck & Co. (1955) 44 C2d 136.

In Sears, the landlord executed a lease with Sears in which the premises were “to be occupied for the sale and storage of general merchandise and for serving automobiles, automobile tire, batteries and accessories” for a period of 10 years. Sears promised to pay as rent for said demised premises “minimum monthly payments” plus “additional percentage rent” calculated on store sales.

After operating a retail sales business in the building for several years and paying both "minimum monthly payments" and "additional rent," Sears transferred its sales business to another location and used the premises solely for the storage of merchandise. Only "minimum monthly payments" were made during the final year of the term, and the lessor sued to recover "additional rent" for that year. Sears, contended that because the
lease did not expressly require it to continue in operation at the premises, it could simply move out and pay the minimum rent.

The Supreme Court ruled, however, that if the minimum rental were not substantial or adequate, and if the rental included a percentage rent provision, then the tenant was required to use good faith to insure a continuation of its business. Where the percentage rent provision accounts for much of the rental income, closure of the business does not discount the rental intentions of the parties.

The American Law Reports (170) states "greater leeway is allowed to the lessee of a percentage lease with respect to the use and occupancy of the premises and the conduct of the business contemplated where there is a substantial guaranteed minimum rental, upon which the lessor mainly relies, with a percentage of the income made an additional obligation, than where the sole rental is made payable from a percentage of the income." Hence, the intention of Lippman and Sears in regard to the monthly payments is of decisive importance in determining the rights of the parties.

Absent an express covenant, the tenant is not contractually bound to operate its business at the premises, but may be bound to pay full rent as if they did. In Bastian v. Albertson’s Inc. 102 Idaho 909 (1982, App), the supermarket owed rent at $ 1,000 per month or percentage of gross retail sales, whichever was greater. The appellate court found that the trial court did not err in finding that there was no implied covenant to continue operation of supermarket upon the premises until end of lease, but that there was an implied covenant that lessee would pay reasonable and adequate rent to the lessors’ during time lessee chose not to operate supermarket, an amount greater than $ 1,000 per month.

Many landlord lease forms provide that, for the purpose of computing percentage rent, the tenant's sales for any period during which the tenant is closed for business shall be deemed to be the tenant's sales for the corresponding period during the last calendar year that the tenant operated from the premises. This provision, at a minimum, gives the landlord a claim for additional damages in the form of lost percentage rent if the tenant fails to operate at the premises as required under its lease. Many national or major regional tenants, however, demand the right to "go dark" and refuse to pay percentage rent for periods that they are closed for business. In these leases, the landlord may seek to (1) terminate the lease if the tenant ceases operating at the premises and relet the premises to another tenant who will operate its business and pay percentage rent, or (2) negotiate higher fixed periodic increases in the rent to compensate the landlord for the tenant's failure to pay percentage rent if the tenant goes dark.

No Implied Covenant in Percentage Rent Lease

In Cousins Inv. Co. v. Hastings Clothing Co., 45 Cal.App.2d 141, the lessee had occupied the premises for several years under a written lease calling for the payment of a monthly rental of $2,750. The lease was renewed but with the rental increased to $5,500 per month plus taxes. After the lessee had found it difficult to pay that amount of rent, the parties agreed to a revision of the lease to provide for a "reserved rental" of $4,000 per
month plus 5 1/2 per cent of the gross income to be paid in such a manner as to limit the total rent during a six-month period to an average of $5,500 per month. With a little more than a month remaining under the revised lease, the lessee removed to a different location and, for the final month, paid only the minimum rental. The lessor sued for rent upon the theory that after the lessee had impliedly covenanted to remain in business at that location for the full term of the lease, he breached that covenant. The court held there was no such covenant. There was nothing in the nature of the transaction, it concluded, "to justify a finding that the implied covenant was indispensable to effectuate the intention of the parties, nor can it be supported on the grounds of legal necessity. On the contrary, as defendant argues, it would seem that the covenant to pay the minimum rental was inserted in the lease as a substitute for an express covenant requiring the continuous operation of the demised premises; that when the rental reserved in a lease is based upon a percentage of the gross receipts of the business, with a substantial, adequate minimum, there is no implied covenant that the lessee will operate its business in the demised premises throughout the term of the lease."

This conclusion was followed in Masciotra v. Harlow, 105 Cal.App.2d 376. In that case the defendant leased property for the purpose of operating a restaurant, promising to pay a monthly rental of 7 per cent of the gross receipts with a minimum of $250. After several years of successful operation under the name "Pump Room," the defendant opened a new restaurant at a different location, transferring the name "Pump Room" and two-thirds of the personnel to the new location. Defendant continued to operate a restaurant on the old premises, but business fell off and the rentals remained at the minimum. The lessor sued contending that "there is an implied covenant that lessee would, during the term of the lease, so conduct his business on plaintiff's premises as to make it mutually profitable to both parties." The court refused to imply a covenant, concluding that "the parties considered the stipulated minimum rent to be in itself fair and adequate and any additional sum was in the nature of a bonus which the lessee was willing to pay if his business exceeded his expectations."

In both the Cousins and Masciotra cases the minimum rental provision was held to be adequate and substantial. Neither decision, therefore, is squarely authority for the proposition that a covenant to remain in business may be implied from an inadequate or insubstantial minimum, and no case has been found which so holds. However, that legal principle follows logically from the rule which permits the implication of a covenant to remain in business where the rent is based entirely upon a percentage of sales, and by their reliance upon the conclusion that the minima involved were adequate, the Cousins and Masciotra cases lend support to that view.

**Multiple Factor Percentage Rent Test**

Some courts will consider numerous pertinent factors in determining whether the percentage clause should be enforceable after store closure. For example, the United States District Court for the Eastern District of Kentucky has stated that courts usually also consider "(1) whether base rent is below market value, (2) whether percentage payments are substantial in relation to base rent, (3) whether the term of the lease is lengthy, (4) whether the tenant may sublet, (5) whether the tenant has rights to fixtures, and (6) whether the lease contains a noncompetitive covenant." Lagrew v. Hooks-Supex, Inc., 905 F. Supp. 401 (E.D. Ky. 1995).
Among courts considering the factors set forth by the Lagrew court, the first listed factor regarding whether base rent is below market value is often seen as the most important and a necessary prerequisite for a court to find an implied covenant to operate. BVT Lebanon Shopping Center, Ltd., v. Wal-Mart Stores, Inc. No. 01-A-01-9710-CV00607, 1999 WL 236273 (Tenn. Ct. App. 1999). A lessor must show disparity between the fixed minimum rent (i.e., the non-percentage rent component) and fair market value.

Assuming that the first factor has been satisfied, courts considering the Lagrew factors look to the other five factors as additional indications of whether the parties intended for the tenant to be continuously operating, and therefore, an indication of whether an implied covenant exists. These courts are more likely to find an implied covenant to operate if, in the analysis of these factors, the court finds the existence of (a) high percentage-rent payments, (b) a long lease term, (c) significant restrictions on a tenant’s ability to sublease, (d) significant restrictions on a tenant’s ability to remove its fixtures, and (e) the presence of a non-competition covenant. However, these courts have not found it mandatory that all of these factors must be satisfied to find the existence of an implied covenant to operate continuously. The facts and circumstances of each situation need to be examined in connection with applicable state law.

**Measure of Damages**

For breach of an implied covenant to remain in business, the measure of damages ordinarily is the amount which the lessor would have received from his share of the proceeds of the business had the lessee operated it in its usual and customary manner, Marvin Drug Co. v. Couch, 134 S.W.2d 359. In Marvin, the parties made specific provision for the payment of damages in the event the lessee ceased to occupy the premises. If it sublet or assigned them, it guaranteed that the lessor would receive "the average monthly rental paid by tenant to landlord during the twelve months' period last preceding such subletting or assignment." In the event the lessee abandoned the premises, it agreed to pay as damages the difference between the best rent obtainable by the lessor from a reletting of them and "the rent herein reserved." In effect, these provisions liquidated the damages to the lessor from a loss of a percentage of the income from the lessee's business if it ceased to occupy the premises. It is a reasonable implication from these provisions that the parties agreed upon the same measure of damages when that loss resulted from an abandonment of the integral purpose for which the lease was made. There was no error in the award of damages.

**Landlord’s Duty to Maintain Third Party Leases**

The Landlord's damages may also extend to liability to other tenants in the shopping center. For instance, the closure of an anchor could expose the ownership to a claim for breach of an express or implied covenant to provide a vibrant and active shopping center for the tenants' benefit. This duty may arise from express cotenancy provision in the lease agreement. Such provisions typically allow for reduced rent in event the shopping center falls below an established vacancy requirement. In the absence of an express provision, an aggrieved tenant could argue the existence of Albertson's at
time of lease execution or a drop in sales resulting from the Albertson’s closure gives rise to an implied duty on the part of landlord not to subject tenant to a “ghost town” effect.

In Cordonier v. Center Shopping Plaza Associates 82 CA3d 991 (1978), the court found that when a lease expressly required that the shopping center landlord "enter into" leases with three anchor tenants for 20-year terms before the commencement of the tenant's lease, the lease included "an implied covenant of the landlord not only to obtain but to exercise good faith to maintain" the other leases. The court cited numerous out-of-state cases in which the interdependence of major satellite tenants has been acknowledged.

**Prospective Diminution in Shopping Center Value**

A tenant who breaches an operating covenant contained within a shopping center lease agreement may be liable, depending on the tenant’s relationship to the rest of the center, for a broad spectrum of damages flowing from this breach. In Hornwood v. Smith’s Food Kin No. 16, 772 P.2d 1284 (Ve. 1989) a supermarket tenant breached his operating covenant and the landlord sought consequential damages based on the diminution in value of the shopping center. The court found that the tenant, as an anchor, (1) drew the largest amount of customers (2) attracted other satellite tenants (3) was essential for long term financing. When the anchor tenant left, the rental value of the shopping center immediately decreased by virtue of the vacancy, discouraging replacement tenants and customers and thereby decreasing the overall value of the center.

**Conclusion**

If a landlord believes that it is essential for its tenant to operate continuously, then an express operating covenant should be negotiated and included in the lease. This clause can have a major impact on both parties over the course of a lease term, so it is important that all relevant issues are addressed during the negotiation and drafting of the lease. If a landlord does not include an express covenant to operate continuously in situations where it is appropriate, then the landlord does so at its own peril. Although some courts have recognized implied covenants to operate continuously in certain instances, implied covenants are generally not favored.

While implied covenants are disfavored, such covenants will be enforced where justified based upon legal necessity. Each case is fact specific. Factors considered include the manifested intention of the parties at the time of lease execution reflected in the difference between base rent and percentage rent (and their relationship to market rent), the length of lease term, tenant’s ability to sublease, fixture rights and noncompetitive covenants. Such factors will be considered in determining whether courts will enforce an implied covenant to operate or require a lessee to compensate the landlord as if one existed. Store closure may also expose the landlord to third party tenant claims and diminished asset value, among other hardships.
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