To Eat or Be Eaten: An Introduction to Restaurant Leasing (with Due Diligence Checklist)

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WHAT MAKES restaurant leasing different from office leasing, and how do those differences impact the lease negotiation process? These are the fundamental questions this article will attempt to address.

Most basically, restaurants are expensive to build, requiring installation of special systems; may place unusual burdens on some of the building systems; require a large number of permits to operate; often fail; deal in food, drink, and party-goers; and, if improperly or carelessly managed, can cause problems for the neighbors. These factors are the driving forces in lease negotiations. At the end of the day, if everything works, everyone will be happy—the landlord and building occupants will have a great new restaurant and the restaurant will be successful and become a neighborhood fixture. If everything doesn't work, the problems can be large, ugly, and expensive to deal with. And therein lies the heart of the lease negotiation.

This article is intended to summarize the issues that are typically raised in connection with the negotiation of a restaurant lease for an independent restaurant operator, is not intended to provide an exhaustive discussion of all issues, does not cover sales of restaurants (which raise additional issues, including sales tax, although many of the issues discussed in this article have relevance to a restaurant sale),[1] and is focused primarily on restaurants in office buildings and multiple dwellings, rather than on shopping

[1] For an excellent article on buying and selling restaurants in New York City, *see* Donald M. Bernstein, *How to Buy and Sell a Restaurant*, Program Materials Presented at the City Bar Center for Continuing Legal Education, New York City Bar (April 22, 2015).

center, food court and hotel leases. As with all leases, the attorneys for the parties need to bear in mind that each lease is its own negotiation with its own issues, risks, and "flavor." Flexibility, coupled with a realistic acknowledgement of the risks, is essential to restaurant leasing.

DUE DILIGENCE • A restaurant lease usually involves more due diligence than a typical office lease. The landlord needs to understand the demands that will be made on building systems and have adequate assurance that the tenant will in fact be able to construct and successfully operate a restaurant. The tenant needs to determine whether it will be able to obtain a liquor license (if it intends to serve liquor), whether the building's systems will support a restaurant and the cost of constructing, opening, and operating the restaurant.

Liquor License

For any restaurant that intends to sell liquor, the first question is whether a liquor license can or will be issued for the premises. In New York, issuance of a license depends, among other things, on the location of the restaurant, the identity and history of the tenant's principals, the identity and history of the landlord's principals, and the sources of the tenant's funding. Local opposition, although not necessarily determinative of whether or not a license will be issued, may slow the process of obtaining a license or bring to light issues that will result in the denial of a liquor license. Accordingly, before the landlord and tenant invest significant amounts of time and money in negotiating a lease, they should each have a good idea as to whether or not the tenant will be able to obtain a liquor license.

A tenant planning to serve liquor should engage an attorney knowledgeable in liquor license issues *before* becoming deeply involved in lease negotiations. The key is to engage the liquor law attorney to "vet" a prospective site before becoming heavily invested in the space. In the State of New York, issues that should be investigated include:

- The property's location (a location too close to a school or church can result in denial of a license, as can a location in an area already oversaturated with bars);
- Whether a liquor license previously issued for the premises has been revoked;
- The criminal backgrounds of the tenant's investors;
- The likelihood of local opposition; and
- Any history the tenant's principals or the landlord's principals may have with the New York State Liquor Authority. The landlord should be aware that it will have to cooperate with the tenant's efforts to obtain a liquor license and will be required to disclose the identities of its own principals, officers, and directors to the New York State Liquor Authority.

The process of obtaining a liquor license was once long, arduous and fraught with peril. Today the process is much less arbitrary. However, if the success of the restaurant is dependent on the sale of liquor, the tenant should have the right to terminate the lease if a license isn't issued by an agreed date. If the tenant can't succeed without serving liquor, the landlord should also have the right to terminate because the landlord will want to end the pain and move on to the next transaction. If a termination right is incorporated into the lease, the landlord should consider whether or not it's willing to allow the tenant to start renovations before the license is issued, since it will not want to be left with a half constructed site or mechanics liens if the termination right is exercised. The parties should also consider whether or not the tenant will pay rent, or some percentage of the rent, during the contingency period. If the tenant doesn't pay rent during that period, the landlord will usually want to be compensated for some or all of the time the space was off the market while the tenant prosecuted its

liquor license application and possibly for some or all of its legal expenses; and it should have the right to deduct that compensation from the security deposit and prepaid rent.

If there is a contingency or termination right, each party should obtain some assurances and commitments from the other party. The landlord should agree, at no out-of-pocket cost to landlord, to reasonably cooperate with tenant's efforts to obtain a liquor license; and represent that none of the landlord's principals, officers, and directors have been barred from being granted a liquor license or have lost a liquor license. The tenant should represent that it and each of its principals are proper persons to obtain a liquor license, that neither the tenant nor any of its principals are disqualified by statute from obtaining a liquor license, that neither the tenant, nor any of its affiliates, has had a liquor license revoked or refused, that none of the tenant's principals have ever owned an equity interest in an entity whose liquor license has been revoked, and that tenant has sufficient funds from sources acceptable to the New York State Liquor Authority to enter into the lease and build and open the restaurant. The tenant also should agree to diligently apply for and prosecute the license application. If the license is not issued within the agreed time period, the lease should terminate and, provided the tenant has not made any material misrepresentation and has complied with its obligations, the landlord should refund to the tenant all or part of its security deposit and prepaid rent (less any agreed compensation). If the tenant has made a material misrepresentation or has failed to diligently pursue the liquor license, then the landlord should have a right to damages. Since damages may be difficult to prove, the lease should provide for liquidated damages and the right to deduct those damages from the security deposit and prepaid rent.

Certificate of Occupancy

Another critical permit is the certificate of occupancy or occupancy permit (however denominated) issued for the building and/or the space by the local building department. Aside from the fact that the tenant needs to operate its restaurant in a legal space, the required restaurant licenses and permits (e.g., liquor license, food service license) will not be issued unless the space has the necessary occupancy permit from the local building department.

If the space is already legally occupied by a restaurant, there is not likely to be an issue, although that should be confirmed with an architect. However, if the space is not already legally used as a restaurant, there may be expensive issues to address; and both landlord and tenant should consult with an architect to determine what those issues are. The issues include:

- Whether zoning permits restaurant use;
- Whether it is possible, on an economic basis, to convert the space to a restaurant given the physical characteristics of the space;
- Whether there are existing building violations that will have to be cured and discharged;
- Whether the entire building, or parts of the building outside of the premises, will have to be brought up to current building code requirements; and
- Whether existing open alteration applications filed by other tenants (or landlord) will have to be signed off or withdrawn.[2]

If issues outside the premises will have to be addressed, the question becomes whether the landlord will undertake to deal with those conditions, the cost to cure, the time needed to cure, and whether the cooperation of other building tenants will be

[2] Note that it is sometimes possible in New York City, and possibly other jurisdictions, to obtain a certificate of occupancy for only part of a building (e.g., the restaurant). An architect or building code consultant should be consulted about such issues at the *beginning* of the due diligence investigation.

required to solve the problems. Sometimes these questions lie in a gray area and cannot be answered immediately. In that event, the parties need to think about risk, responsibility, and abatement and termination rights.

Because it takes a very long time to obtain a certificate of occupancy and can be difficult to amend one, in New York City it would be fairly unusual for a restaurant tenant to set up shop in a building in which it has to either obtain or amend a certificate of occupancy (except in a new building under construction).

Other Permits

Many permits and licenses are required for restaurant operation. Some of those permits are listed on Appendix 1 at the end of this article. In New York City and some other jurisdictions, the tenant typically engages a specialist to shepherd it through the permit process.

Equipment Included—Sales Tax and Title Issues

If the landlord is leasing space that has been vacated by a prior restaurant tenant and the lease gives the new tenant the right to use the prior tenant's abandoned furniture, fixtures, and equipment, there may be sales tax and title issues that should be addressed. If the landlord sells the equipment to the new tenant, there will be sales tax. If the equipment is included in the lease rental and the parties fail to allocate rent between the real estate and the equipment, there is the possibility that the State of New York will do the allocation for the parties, imposing sales tax on an "assumed" equipment "rental," and the result may not be pretty.[3] Accordingly, if furniture, fixtures, and equipment are included in the lease, the landlord should consult an accountant familiar with sales tax issues to avoid potential liability for sales tax.

If the landlord is leasing space equipped with furniture, fixtures and equipment owned by a prior tenant that has abandoned the space, it should take care to disclaim any warranty of title, as it is possible that an equipment vendor will at some point assert title to some or all of the equipment. If the equipment is valuable and its loss would affect the price or rent the tenant is paying, then the parties should provide for an equitable reduction in the price or rent if any of the property is seized.

Building Systems

Restaurants require, among other things, a lot of electric, a lot of air conditioning, hot water, heat during days, nights, and on weekends, an exhaust system, grease traps, and adequate plumbing, sewer and drainage lines. Those issues are described below.

HVAC&R

"Serious" air conditioning and ventilation is required for restaurant space because of the heat generated by cooking and by the presence of many people in tight quarters, requiring installation of one or more HVAC units. In addition, the tenant may need refrigeration units for cold rooms and other refrigeration equipment, which will require installation of additional compressor units. Although the building may provide some heat to the space, the amount provided may be insufficient, unreliable, or not provided at night or on weekends (when the restaurant operates), necessitating installation of a heating unit. Because space is at a premium in most restaurants (the more seats, the better!), the tenant will want the right to install such equipment outside of the premises, and this will require landlord consent. If the tenant installs the equipment in a common area and fails to obtain the landlord's written consent, it can run into major problems down the road, when the landlord (or a new landlord) devel-

[3] Allocation may not be as great an issue in New York City, which imposes Commercial Rent Tax on tenants.

ops other plans for the space the tenant is then using for its HVAC&R equipment. Accordingly, the tenant should ensure that the landlord either consents in the lease to the installation of such equipment in a designated common area, or, at a minimum, agrees to be reasonable about designating a common area location where the equipment may be installed. Areas for consideration will include the roof, the exterior of the building, the backyard and/or a side yard. The landlord should normally consider reserving the right to relocate the tenant's equipment to a different location reasonably designated by the landlord, so that the landlord can, if it so desires, re-purpose the designated common area. If the landlord wants the option to relocate the equipment, the tenant should seek to have the landlord pay the cost of relocation.

Hot Water

The building may not provide hot water to the restaurant space, necessitating installation of a hot water heating unit. If hot water is furnished to the premises through a building system at lease commencement, the landlord should reserve the right to require the tenant to install its own hot water system, as a restaurant's needs for hot water are likely to substantially exceed the needs of other tenants.

Electric

Restaurants generally require more electric service than office uses. Therefore the adequacy of the electric should be carefully investigated. If more electric service is required, the tenant and landlord need to determine if the building has enough surplus electric capacity for landlord to allocate more electric to the premises and, if not, the cost of bringing to the building and the space additional electric capacity. Because restaurants use so much electricity, a restaurant tenant will want to obtain electric directly from the utility company if at all possible, rather than paying for electric on a submetering or rent inclusion basis (which usually includes a fee to the landlord); unless the submetering can be structured in such a manner as to provide the tenant with cheaper electric than it could otherwise obtain on a direct meter basis.

If the building is multi-tenanted, the tenant should also confirm that the meter(s) measuring electric service to the restaurant measure only electric consumption in the premises. In small, multi-tenant buildings, it is not unusual for the restaurant's meter to also pick up ground floor common area electric.

Gas

The tenant also needs to confirm there is adequate gas service to the premises (for cooking and possibly for ambient heat and/or a hot water heater); and, if not, determine the cost of installing a new gas line and obtaining gas service from the utility. The landlord should be required to reasonably cooperate at no out-of-pocket cost to the landlord.

Steam

If the restaurant will need steam (for cooking and/or heating the premises), the tenant needs to investigate whether steam service is available and adequate and, if not, determine the cost of bringing steam to the premises. The landlord should be required to reasonably cooperate at no out-of-pocket cost to the landlord.

Utility Services Generally

In all cases, if a new utility (gas, steam, electric) has to be brought to the premises or if the amount of service to the premises needs to be increased, the tenant will need to ascertain if the new or additional service can be obtained from the utility and at what cost. The tenant should also require the landlord to reasonably cooperate with the tenant's efforts to obtain or increase such service, at no out-of-pocket cost to landlord, and obtain the landlord's consent in the lease to tenant's installation of the appropriate conduit, ducts, and equipment in the building's

common areas at locations reasonably acceptable to the parties. If significant sums have to be spent to install new service or increase existing service, there may also be a discussion about having the landlord share in the cost through a construction allowance or rent concession.

Exhaust System

Restaurants typically need to design and install an exhaust system that includes one or more stacks or flues (and fans) that are used to vent odors and smoke from cooking, fumes from gas or oil operated hot water heaters, and/or fumes from gas or oil operated heating units providing ambient heat to the restaurant. Local building codes may require separate stacks to be installed for each different source of fumes. None of the fumes generated by the restaurant should be vented through the building's existing boiler stack (providing ambient heat to the building) if active. If the restaurant is a single building on its own pad, venting is not likely to be much of an issue; but if the restaurant is on the ground floor of a multi-tenanted building, the tenant may have to install multiple stacks and fan motors. Accordingly, if the existing exhaust system is non-existent, a new system will have to be installed. If the existing exhaust system is inadequate or in disrepair, the tenant will have to repair and replace the system as needed. The installation, repair and/or replacement of an exhaust system can be very expensive. Installation of a new stack will require the landlord's consent, since the stack will almost certainly have to be installed in building common areas or tenanted areas. For example, the tenant may have to install its stacks on the exterior of the building; or the tenant may install duct work in existing riser space that runs through the building, including through other tenant space. In either case, the tenant will need the landlord's consent to placement of the stack at a location outside of the premises. If the tenant plans to use an existing stack, the tenant should have the landlord consent to the tenant's exclusive use of the stack. In either case, the landlord should be asked to grant the tenant a right of access to relevant areas of the building to enable the tenant to install, maintain, use, repair and replace the exhaust system, and, if any stack runs through another tenant's space, the landlord should be asked to cooperate with the tenant's efforts to gain access to those areas.

If the restaurant utilizes an exhaust system with flues and fans, the landlord should require the tenant to maintain a service contract, satisfactory to the landlord, covering the system; and should reserve the right to relocate some or all of the exhaust system, to the extent located outside of the premises, to a reasonably designated location elsewhere in the building. As with the HVAC system, the tenant will want the landlord to pay for the cost of relocation.

Sewer, Drain Lines, Grease Interceptors

With respect to drainage lines, the tenant and landlord need to focus on both the drain lines leading from the tenant's space to the building's common lines, and the common line leading to the street main, because the grease and other waste generated by a restaurant can clog the common lines as well as the restaurant's dedicated lines. The size and condition of the lines should be investigated before the lease is signed. If the lines are inadequately sized or in poor condition, they will have to be replaced, which will trigger a negotiation as to who bears the cost and who performs the work. The tenant also needs to determine if there's a grease trap serving the premises, if it's in good condition, and whether or not it will have to be replaced.

Water

Restaurants use a lot of water and the landlord should ensure that the tenant pays for its own water usage. If the space is not separately metered or submetered for water, either the tenant or landlord should be required to install a meter. If the restaurant is not metered for water consumption at the

commencement of the lease, the landlord, at a minimum, should retain the right to submeter the tenant's water consumption.

Sprinkler

If the premises are not sprinklered, they may (or may not) have to be sprinklered, depending on local code requirements and insurance requirements. Sprinklering may involve installation of, among other things, a sprinkler riser, sprinkler loop, and sprinkler heads; together with connection of the sprinklers to a fire-safety system. The parties need to determine who will pay these costs.

Systems Generally

In short, both the tenant and the landlord need to focus on the suitability of the space for restaurant use, what new systems have to be installed, where the new systems will be installed, and which existing systems need repair or replacement. The first question is who pays for the cost of installing a new system or repairing an existing system. If new systems, and related ducting, equipment and conduit, need to be installed in common areas of the building, the tenant needs to have the landlord consent to an agreed location or, at a minimum, agree to act reasonably in determining the location of the new system and related duct work, conduits and equipment. If there are existing systems serving the premises, the landlord should agree to allow those systems to remain in place and grant tenant the exclusive right to use the systems. Tenant also should have a right of access to all systems that are located outside of the four walls of the premises in order to maintain, repair and replace same. If parts of those systems run through other tenant space, the landlord will not be able to guaranty access; but should agree to cooperate with tenant to provide such access and to take any necessary action (at whose cost?) needed to provide such access.

Accessibility and Bathrooms

A restaurant is a "place of public accommodation" under the Americans with Disabilities Act and is therefore subject to its physical accessibility requirements. Local codes may impose additional accessibility requirements. This makes bathrooms a hot topic in the restaurant world, both because a substantial number of toilet fixtures will have to be installed to meet code requirements and because bathrooms will have to be accessible to the extent feasible. Bathrooms are, therefore, a very expensive part of the construction pie.

Another hot-button accessibility issue is the entrance to the premises. If the space is not accessible (for example, there are steps leading to the entrance), the first question is whether applicable law requires the entrance to be made accessible. If, for example, the premises are in an old building that is located on a street with narrow sidewalks, is tightly fitted between two other buildings, and has steps leading to the front entrance (think Greenwich Village in New York City), it may not be feasible or legally required to provide accessible entry through the front door, a side door or a back door. However, even if it is not feasible or legally required to make the space accessible, there may still be lawsuits and claims based on lack of accessibility of the premises. Most, but not all, lease indemnification clauses are broad enough to make the tenant responsible for such lawsuits, which the tenant may perceive as unfair since the lawsuit arguably arises from the building's original construction and not from the tenant's acts. The landlord, on the other hand, will view an accessibility lawsuit as a problem that arises from the tenant's use of the premises (as a place of public accommodation) and a cost of doing business for the tenant. Arguments aside, the tenant should raise the issue and the parties should determine who is responsible for such lawsuits or whether there should be a sharing of responsibility. If the space can be made accessible, then the major

topic for negotiation will instead be who pays the cost.

Signage Rights

Signage is critically important to the tenant. If the building has a sign band or existing sign frame, the tenant will want the right to install its signage on the sign band or frame. If the restaurant is in a shopping center with a pylon sign, the tenant will want a specified place on the pylon sign. In a shopping center, the tenant will want assurances that the landlord will not alter common areas or permit the shopping center to be altered so as to impair the visibility of tenant's sign (but the landlord will want to exclude from such a clause events that are out of its control, such as a condemnation that affects the visibility of tenant's signage). Perhaps the tenant will want the right to install signage on the building's roof and/or the side of the building. The point is that if the tenant wants the right to install signage at a particular location on the building or property, it should negotiate for the right to install its signage in that location or locations.

Different landlords require different levels of control over signage. In a multi-tenanted building, the landlord and tenant should agree on the location and design of tenant's exterior signage. The landlord will want absolute control of any other exterior signage, and some level of control over interior signage. For example, the tenant may be prohibited from installing any signage on the interior of the storefront windows, or may be permitted to install professionally designed and installed signage on the interior of the storefront windows with possible limitations on the percentage of the window space that may be covered. In a shopping mall, the landlord is likely to retain absolute control over all window signage and any other signage installed within a designated distance of the windows.

Generally, the landlord should seek approval rights over all signage, with an agreement to be reasonable about signage installed in designated locations (such as a sign band). The landlord needs to determine how much control it wants over all other signage, but generally the landlord will want to absolutely prohibit "going out of business" signs (and similar signage), require the tenant to obtain all required sign permits, maintain all signs in good, safe, and attractive condition, in good repair and in compliance with applicable legal requirements, and remove the signage and restore any damage at the end of the lease. If the building is partly occupied by residential tenants, the landlord should consider banning all lighted signs. The landlord should also have the right to temporarily remove signs for the purpose of making alterations and repairs and the right to remove permanently any illegal signs or signs installed or maintained in breach of the lease.

Sidewalk Cafes

If the tenant wants the right to have an outdoor seating area, it will need the landlord's consent and the landlord's agreement to cooperate with the tenant's efforts to obtain any necessary licenses or permits (which will be required if the outdoor seating area is a public sidewalk). In general, the tenant should be required to obtain all required permits, comply with all applicable legal requirements, maintain any outdoor seating area in neat and clean condition, clean the area every night, and maintain order in and about the seating area. The landlord may want to give its consent in the form of a revocable license, and reserve the right to revoke the license if there are complaints from other tenants or the neighborhood about noise, disorderly conduct, or other offensive conduct. Shopping center outdoor cafes raise similar issues, except the landlord must also consider possible disruption of traffic flow patterns within the project and the impact on other tenants.

BROKERAGE • If the lease is in any way conditioned on issuance of a liquor license (through a contingency or termination right), one thing that

goes without saying is that the broker's commission right should be likewise conditioned. A favorable formulation for the landlord would be that no commission is payable unless and until:

- Landlord and tenant execute and deliver a lease;
- The tenant pays landlord the required security deposit and the pre-paid rent due at execution;
- All required approvals and consents have been obtained (for example, lender consent);
- The lease has not been terminated by reason of the tenant's failure to obtain a liquor license within the time period provided in the lease or by reason of the tenant's default during the contingency period;
- The tenant takes occupancy of the premises, opens for business to the general public (private, pre-opening dinners should not count), and pays the first month's base rent that becomes payable after expiration of the rent concession period and application of the rent pre-paid at lease execution.

After the initial conditions are met, the landlord may (or may not) be able to negotiate a pay-out of the commission over time; and if the commission is payable in installments, the landlord's obligation to pay each installment should be conditioned on the tenant being current in its rent payments and on the lease not having been terminated by reason of the tenant's default. The commission on a restaurant lease (in New York City) is typically a percentage of the rent that declines over a period of years.[4]

BASIC ECONOMIC TERMS • The basic economic terms in restaurant leases pertain to rent, the security deposit, the term of the lease, real estate taxes, and operating expenses.

[4] If an existing restaurant is being sold by the tenant, the commission will instead be a percentage (e.g., 10%) of the "key money" paid by the purchaser for the good will and furniture, fixtures and equipment.

Base Rent

Restaurant tenants generally pay higher rent than other retail tenants. Higher rent is viewed as appropriate because a successful restaurant makes a lot of money, but also because restaurant tenancies are "high risk" tenancies, with abnormally high rates of failure and bankruptcy. It is not particularly unusual to see a restaurant location turn over two or more times in a ten-year period. If the tenant files under Chapter 7 of the United States Bankruptcy Code, 11 U.S.C. Sec. 101 et seq (a liquidating bankruptcy) or Chapter 11 (reorganization) and the lease has value, the bankruptcy court may order a sale of the lease and the landlord will find itself with a new tenant and no "say" in that tenant's selection, since assignment and subletting restrictions are not honored in bankruptcy. If the tenant files under Chapter 11, successfully reorganizes, and affirms the lease, the landlord should eventually be made whole if the tenant has defaulted in its rent payments, but the resolution of the tenant's debts and the adoption of a plan under which the landlord is repaid any accrued and unpaid rent, may take some time. Not all failing tenants file for bankruptcy. Some simply disappear into the night. If the landlord leases to a succession of failed restaurateurs who disappear into the night, the landlord may incur significant re-letting costs over a ten-year period, including multiple brokerage commissions, legal fees, loss of rent during each marketing period, and rent concessions granted to each new tenant. Any landlord considering a first time lease to a restaurant tenant, needs to bear these risks in mind; and also to remember that restaurant chains, as well as individual restaurant operations, can fail (although the risk may be lower). For all these reasons, landlords generally adopt a number of precautions when leasing to a restaurant tenant and tend to charge a relatively high rent.

If the tenant's business is likely to derive substantially from the building's occupants and traffic

in and out of the building, then the landlord also may require the tenant to pay percentage rent on top of a base rent.

Free Rent

Restaurant tenants typically demand a significant rent concession as part of the economic package, in recognition of the fact that the tenant will incur very significant costs in constructing and outfitting a restaurant. As noted in the Due Diligence section above, the tenant may have to install new systems or upgrade existing systems, including installing an exhaust system, high capacity HVAC & R units, grease traps, new drainage pipes, new electric risers and other infrastructure improvements. In addition, the restaurant may have to be fitted out with new appliances and trade fixtures, including bars, stoves, refrigerators and refrigeration units, kitchen counters, cash registers, sound systems and furniture; and if the restaurant is a sit down restaurant catering to an upscale clientele, a considerable amount of money will be invested in the restaurant's design and décor. If a tenant is taking over an already constructed restaurant space in reasonably good condition, the rent concession is likely to be modest; but if the restaurant requires a large investment, a significant rent concession is likely to be negotiated.

If a significant rent concession is negotiated, the next question is how it should be applied and the conditions to granting the rent concession. In the bad old days, landlords sometimes gave tenants very long free rent periods that were applied entirely up front. A tenant might sign the lease, pay no rent for the first nine months of the lease term, and use that period to construct the restaurant and open for business. But sometimes the tenant would construct the restaurant, open for business and then close shortly after the rent concession expired, leaving the landlord with no rent for nine months, lots of mechanics liens filed by unpaid contractors, no tenant, and the prospect of having to pay more brokerage commissions to find a new tenant. Landlords today therefore typically seek to spread the rent concession over a period of time. The tenant, for example, might be granted a nine (9) month rent concession, but with only three or four months applied at the commencement of the lease and the balance spread over the remaining term of the lease. There is a yin and a yan, however, to the negotiation; because the tenant's incoming expenses are very high and it most needs a rent concession at the commencement of the lease whereas the landlord faces a significant risk if it allows the concession to be applied entirely at the front end of the lease. The parties' relative interests are likely to end up a compromise between the tenant's need for an immediate concession and the landlord's need for security. Both landlord and tenant should consult with a tax advisor in order to understand the tax ramifications of a large concession, which, for purposes of income taxation, may be spread over the term of the lease.

To the extent the concession is spread over time, both tenant and landlord should carefully draft the conditions to the application of the concession. If the application of the concession is tied into the tenant's never having committed a default under the lease (typical language being: "provided Tenant has not defaulted under this lease …"), the tenant could easily lose its right to the concession since it's very rare that a tenant does not, at some point, default. If the concession, on the other hand, is simply conditioned on the tenant not being in default at the time the concession is to be applied (typical language being: "provided Tenant is not then in default of the lease beyond any applicable cure period …"), the tenant will be entitled to a concession even if it has proven to be a troubled tenant with a poor payment history (although the tenant would argue that history is irrelevant so long as it is not in default at the time the concession is to be applied). There is no right way or wrong way to handle this issue, but it is important that the parties think about the issue

and clearly set out the conditions under which the rent credit or concession will be applied.

Security Deposit

Because of the high risk nature of restaurant leasing, landlords typically require an unusually high security deposit from restaurant tenants, unless the tenant is a major food chain (such as McDonald's). The amount of the deposit will vary significantly depending on the perceived risk, the prior experience of the tenant's principals in the restaurant business and the amount the landlord is investing in the project through free rent, brokerage commission and a construction allowance. If the security deposit requirement is high (e.g., five to nine or more months), the tenant should negotiate a "burn down" of the security over time, on the theory that the landlord will recover its leasing expenses over time, including commissions, free rent and construction allowance, through the rent payments. With security deposit "burn downs," as with rent concessions, the key issue is not just the amount of the burn down and the timing of the burn down, but the conditions under which the burn down will occur. If the burn down is conditioned on the tenant having never been in default of the lease, the tenant may find itself unable to obtain a security reduction even if it has generally been a good tenant. On the other hand, if the burn down is simply conditioned on the tenant not being in default at the "burn down" date, the landlord could find itself having to refund part of the security to a tenant that is not in default at the "burn down" date but that has historically paid rent late and is viewed as a credit risk. A better way to manage "burn downs" is to tie the right to the reduction in security to the tenant's historical conduct (i.e., the tenant has always paid base rent and additional rent within ten days of the due date) or to key the burn down to a minimum net worth or revenue requirement that has been met for a minimum period of time.

Landlords typically prefer the security deposit to be in the form of a letter of credit because of certain advantages letters of credit have in bankruptcy. If a tenant files for or is placed in bankruptcy, all actions and proceedings against the bankrupt tenant and its property are automatically stayed. This "automatic stay" bars the landlord from drawing on cash security because the bankrupt tenant has a "property interest" in the security. The landlord should eventually be able to draw on the cash security—but not until the bankruptcy court vacates the automatic stay as to the security deposit, which may take years. The automatic stay, however, does not bar the landlord from drawing down a letter of credit because the letter of credit is the direct obligation of the *issuing bank* to the landlord; and the tenant, although affected by a draw on the letter of credit, has no property interest in the letter of credit. Landlords therefore prefer letters of credit in high risk situations, and restaurants often present a high risk situation. There are, however, administrative drawbacks to a letter of credit that should not be ignored. If the letter of credit is lost, or a critical notice from the issuing bank is ignored by the landlord's administrative staff, or the landlord changes its address and fails to receive a critical bank notice, the letter of credit may become a worthless (or lost) piece of paper, leaving the landlord completely unsecured. Any landlord requiring the tenant to provide a letter of credit as security needs to be cognizant of the administrative risks and take proper precautions.

Landlords may also consider having the letter of credit secure the obligation of a guarantor, rather than the tenant itself. The reason for the structure, as always, is bankruptcy considerations. If the tenant files for bankruptcy and rejects the lease, the landlord's claim for lease termination damages is capped (the "Cap") under the Bankruptcy Code at the sum of (a) the unpaid rent due as of the earlier of the date the tenant filed for bankruptcy and the date the tenant vacated the premises and (b) the

greater of (i) one year's rent (calculated without any reference to acceleration of rents, even if the lease provides for such acceleration), and (ii) 15% of the rent due for the remaining term of the lease (not to exceed three years' rent). Bankruptcy Code §502(b)(6). The Cap limits the lease termination damages the landlord can realize on its claim against the tenant in bankruptcy, and if the security deposit held by the landlord, whether cash or letter of credit, exceeds the Cap, the landlord will be required to disgorge the excess (subject to a possible exception for other kinds of damages). If, however, a principal of the tenant guaranties the lease and secures its guaranty with a letter of credit, the Cap should not limit the lease termination damages the landlord may recover from the guarantor (unless the guarantor also files for bankruptcy, in which case there is an issue). Before adopting this somewhat tortuous structure, the landlord should obviously evaluate the possible benefits to be realized from a guaranty secured by a letter of credit.

Term

Because the tenant's investment is often substantial, restaurant leases tend to be relatively long term leases, with a minimum term of ten years plus one or more extension options.

Real Estate Taxes

Depending on location, the tenant may pay a percentage of all real estate taxes levied against the property (e.g., 10% or 100% of the property's real estate taxes) or a percentage of increases in taxes over a base year (usually the tax fiscal year in which the lease is signed), as is typical of New York City, or above a "stop" (a fixed amount). The tenant's percentage should, in theory, be a fraction equal to the rentable square footage of the premises divided by the rentable square footage of the entire building or shopping center (and should never be determined with reference to the "leased" area of the building or shopping center). However, measurement standards vary from jurisdiction to jurisdiction and also depend on the nature of the building project (e.g., mixed use office building, strip center, or shopping center). Formulas used in shopping centers tend to take on a life of their own, with possible adjustments of the percentage to reflect additions of new lots, vacancies, and other events. In New York City, ground floor retail and restaurant tenants generally pay a greater percentage of increases in the property's real estate taxes than would be warranted by the square footage of the premises because a commercial building's real estate taxes are determined largely with regard to the property's income, and the ground floor retail/restaurant tenants usually generate a disproportionate share of the building's income (the landlord's reasoning is that the restaurant tenant should pay an increased share of the building's real estate taxes because the income from the tenant's restaurant is driving up the tax bill).

Operating Expenses

Restaurants in stand-alone buildings usually pay all the expenses of operating the building, with the possible exception of roof repairs and structural repairs.

Restaurants in shopping centers often make heavy use of the shopping center's common areas (e.g., parking and walkways), and therefore generally pay a percentage of the common area costs.

An anchor tenant in a strip center will pay a percentage of the common area costs but may be able to negotiate annual caps (e.g., 5%) on its liability for certain common area "controllable" costs (i.e., anything other than real estate taxes, snow removal costs, insurance costs and any other items that landlord and tenant may agree are not controllable).

In a mixed use building, the ground floor restaurant tenant needs to ensure that, to the extent it pays a share of the building's operating expenses, those expenses do not include charges for services and equipment that do not serve the tenant. For example, if a ground floor restaurant tenant in an

office building does not use the building's elevators, provides its own heat and air conditioning, and pays the utility directly for its electric, gas and water consumption, then none of those expenses should be factored into the computation of the tenant's operating expense bill. Conversely, landlords of mixed use buildings, to avoid disputes and disagreements with other tenants, should ensure that restaurant tenants pay separately for utility services, or be prepared to deal with complaints of other tenants that they are subsidizing restaurant costs.

OTHER LEASE PROVISIONS • Because of the risks, rewards, and cost of restaurants, restaurant leases often contain the provisions described below. Many of these provisions are found in office and retail leases in one form or another, but receive steroid treatment when applied to restaurant leases.

Licenses

The tenant should be required to maintain all licenses and permits required for the operation of the restaurant, including, if liquor is sold, a liquor license.

Assignment and Sublet

Leases typically require landlord consent, not unreasonably withheld, delayed or conditioned, to assignments and subleases. Most leases also prohibit encumbrance of the lease by the tenant, prohibit any occupancy of the space by a third party, and provide that a transfer of a majority of the equity interests of the tenant is deemed an "assignment" requiring the landlord's consent. All of these provisions can create serious problems for restaurant tenants. Therefore it is important to discuss the assignment and sublease restrictions with the tenant and understand the tenant's business needs.

For example, if the tenant is relying on investors for funds, those investors need the right to freely sell their interests. If the tenant is, or is owned by, a publicly owned corporation, it will not agree to a provision making a transfer of equity interests an assignment requiring the landlord's consent. The landlord should be willing to acknowledge the reality of the tenant's financial structure, but needs to consider what controls might be reasonable. For example, if the tenant's funding source is investors who need the right to transfer their interests; the landlord should be willing to permit such transfers so long as the "chef" (or driving force) behind the restaurant retains a significant equity interest in the tenant and retains control of its management.

If the tenant is owned by only one or two people, the tenant will want assurance that the death or incapacity of a principal will not be deemed a transfer that trips a default under the lease or, alternatively, may want the right to terminate the lease. If the "key man" dies and the restaurant seems unlikely to be able to succeed without him or her, the landlord will want the right to default the tenant (hard-hearted though that may be), but may be willing to give the tenant a termination right upon payment of a termination fee. The landlord also may want to consider requiring the tenant to carry "key man" insurance so that if anything happens to the restaurant's principal operator, there is enough money to carry the restaurant until the disposition of the restaurant can be sorted out.

If the tenant is starting up the restaurant with the idea of selling it, it should negotiate the right to sell its business (including through an assignment of the lease, sublease of the premises, a combination of assignment and sublease, or merger) without the landlord's consent or with the landlord's consent, not unreasonably withheld, conditioned or delayed. If the landlord is willing to permit such a transfer (which is not a foregone conclusion), it should impose minimum requirements, including a requirement that the buyer, or its principal shareholder, partner, or member, be an experienced and successful restaurateurs and that the net worth of the new tenant at least equal the net worth of the transferring tenant. There may also be discussions about

increasing the rent. In addition, since the sale may be effected through an assignment to the purchaser, collateral re-assignment back to the original tenant, and/or a sublease of the premises to the purchaser, all such transactions should be covered by the assignment and sublet clause.

If the tenant plans to license an operation at the premises (for example a baked goods or ice cream take-out counter), it will need to modify the assignment and sublease clause to permit such a transaction.

In short, the tenant's business needs and plans for the future may necessitate modifications to the assignment and sublet clause, and the tenant's attorney needs to understand those needs and goals.

In addition to basic consent issues, the tenant's attorney should review the assignment and sublease clause for unacceptable provisions. Since the ability to sell the restaurant is usually a critical issue for the tenant, the tenant's attorney should seek to eliminate the recapture clause (which allows the landlord to terminate the lease upon a proposed assignment or sublease), the profit recapture clause (under which the landlord takes a portion of any profit generated by the assignment or sublet), any requirement that the tenant use the landlord's broker for an assignment or sublease, and any other inappropriate clause. Since the tenant may, if it sells the restaurant, enter into a sublease arrangement, the tenant should seek to include a provision requiring the landlord to give any prospective subtenant a recognition agreement and should also confirm that the lease does not prohibit subtenants from further subleasing or assigning their subleases or assignees from further subleasing or assigning. As with any assignment/sublease negotiation, if a principal of the tenant has given the landlord a guaranty of any kind (including a "good guy" guaranty), the tenant's attorney should request the ability to replace the guarantor upon a permitted assignment or a sublease of all of the premises for substantially all of the remaining term.

If the restaurant is being leased to a restaurant franchise, then special provisions will be required. Among other things, if the original tenant is the franchisor or an affiliate, it will want the right to freely assign or sublet to any of its franchisees and to take back the premises in case of a franchisee default. In such a case, the landlord will want to include language making it clear that the original tenant remains liable, that any franchisee be an experienced restaurant operator and an authorized franchisee, and that the restaurant be operated under the tenant's trade name unless the landlord otherwise consents. If the original tenant is the franchisee, then a major issue is whether loss of the franchise should be an event of default or if the tenant may reinvent itself in the space.

Liens

Leasehold mortgages and liens are always prohibited by the landlord's standard form of assignment clause. The alterations clause or other lease provision may also prohibit the tenant from buying furniture, fixtures or equipment under conditional sales contracts or from granting a security interest in its property. In some states (not New York), a landlord may have a statutory lien on the tenant's property. These restrictions may create a problem for the tenant. Restaurant equipment is expensive and is often purchased on "time," with a financing statement filed to perfect the vendor's security interest. The tenant should put its needs on the table and obtain the landlord's consent to such an arrangement or be prepared to pay cash. The landlord may be willing to allow a security interest to be granted in certain classes of property (e.g., furniture and kitchen appliances), but not in equipment that is expected to become part of the premises and that is being funded in part by the landlord through free rent or a construction allowance (such as HVAC equipment). If the tenant will be financing its furniture and equipment purchases, it should also negotiate for the landlord's agreement to give

the tenant's lender, upon request, an access agreement in form reasonably acceptable to landlord permitting the lender to enter the premises after a lease termination to repossess the equipment. Any such access agreement should cover the length of time the lender will be granted access, payment of rent for the period of time that the landlord makes the premises available to the lender after obtaining possession, and the lender's agreement to indemnify the landlord against any loss, claims, and expenses arising from any accident or injury arising from such entry or from any claim made by tenant against landlord for permitting such entry. The tenant should, of course, consent in writing to the terms of the access agreement.

Occasionally, a tenant intends to borrow money through the Small Business Administration or other institutional lender and such lender requests an assignment of the lease. Most landlords will not agree to such an assignment, but if the tenant's attorney is aware at the time that the lease is being negotiated that the tenant may borrow money from an institutional lender to finance the construction, the issue should be discussed and the proposed lender consulted about its requirements. Since the assignment of a lease as security for repayment of a loan can trigger mortgage tax liability in some states, it's in the tenant's interest to avoid a collateral assignment of the lease.

Permitted Use

The tenant comes to the landlord with a description of an elegant candlelit restaurant. The landlord's fully on board. Two years later, the space is being operated as a greasy spoon take-out joint, with hamburger and hot dog wrappers littering the sidewalk. What happened? The answer is probably that the elegant, candlelit restaurant didn't work, and the use clause was broadly drafted to permit any "restaurant" use. And therein lies the rub. The tenant needs some flexibility in the use clause because if its original concept doesn't work, it needs the ability to change concepts. On the other hand, the landlord may be completely opposed to the operation of a casual, take-out restaurant in its building. Out of this tension comes the negotiation, with the tenant trying to maintain maximum flexibility and the landlord trying to at least limit the type of restaurant that can be operated at the premises.

If the tenant is a chain with a lot of leverage and the landlord lacks leverage, the tenant will probably insist on the right to use the space for any lawful use; but if that is the case, the landlord should be able to at least insist that the tenant initially build the restaurant and open it as a "_____" restaurant.

Exclusives

If a restaurant tenant known for selling a particular food product leases space in a building with multiple food uses, it will usually ask for an "exclusive," prohibiting the landlord from entering into a new lease for a food use that competes with the tenant's use. Exclusives should be very carefully drafted by the tenant, and even more carefully reviewed by the landlord. Often exclusives are overly broad, requiring the parties to focus on the tenant's real needs. For example, a proposed exclusive for a Mexican restaurant might prohibit any sale of Mexican food products. Construed literally, such an exclusive would prohibit a delicatessen from selling tortilla chips, notwithstanding the fact that such a use does not really compete with the tenant's use. For that reason, an exclusive will generally prohibit other tenants only from selling the "exclusive" product as their primary food (or drink) product, not from selling it at all. Unclear language can also generate litigation. For example, does an exclusive for sale of "sandwiches," prohibit the sale by another tenant of "wraps"? See Ruth A. Schoenmeyer, Arthur J. Menor and Lawrence S. Delaney, *Is a Burrito a Sandwich?*, ABA Probate & Property Journal, January/February 2014.

In the world of exclusives, landlords should further protect themselves by reserving the right to revoke the exclusive if (or so long as) the tenant goes dark or ceases selling the "exclusive" product as its primary food (or drink) product, and by exempting from the exclusive sales by other tenants of products they are permitted to sell under their existing leases (in which event the prospective tenant will want to review the applicable use clauses).

If the tenant's restaurant is the sole retail use in a mixed use building, the tenant needs to remember that competing restaurants may open in nearby buildings. If the landlord, or its affiliates, own some of those nearby buildings, the tenant may want to negotiate an exclusive that binds the both landlord and its affiliates and covers a defined radius around the tenant's restaurant.

Sidewalk Bridges and Scaffolding

Construction on the tenant's building or even construction by an adjacent property owner may require installation of sidewalk bridges and scaffolding in front of the tenant's building. Sidewalk bridges are anathema to all retail tenants, including restaurant tenants, because sales and business are often adversely affected by the presence of such bridges. Therefore, counsel for a restaurant tenant should seek some protection if the space faces the exterior of the building. Protections might include a ban on scaffolding (except in emergency) during the restaurant's first year of operation (or other period of time), a requirement that the landlord install the sidewalk bridge to double height so as to leave tenant's storefront visible and install adequate lighting around and under the bridge, the right to install (at landlord's cost) tenant's signage on the sidewalk bridge (generally, a non-exclusive right since construction permits must be posted, but there may be a negotiation over the prominence of the tenant's sign), and requirements that the sidewalk bridge be installed no more than thirty days before construction begins, that construction be completed with reasonable diligence, and that the bridge and scaffolding be removed promptly after construction is completed. The tenant might also negotiate for a reduction in rent at some point (or perhaps convert from fixed rent to percentage rent) and even the right to terminate in an egregious situation. The landlord needs to remember that tenant protections cannot be so stringent as to make it difficult or impossible to make needed building repairs, and that if an adjacent property owner requests the right to install scaffolding pursuant to statute, it will have to allow its neighbor to install the scaffolding. In negotiating a scaffolding license agreement with a neighbor, the landlord needs to take into account any obligations it has to its tenants and should perhaps consider requesting a license fee (which may or may not be passed through to the retail tenants).

Quality of Life Issues/Restaurant Operations

If the restaurant is located in a stand-alone building, quality of life issues aren't usually problematic. However, if the restaurant is located in an occupied building, noise, vibration and odor can become a serious problem for the building's other occupants. Although a landlord might initially view noise and odor as the other tenants' problem and not the landlord's problem, once those tenants begin withholding rent, claiming constructive eviction, and threatening lawsuits, the noise and odor generated by the restaurant will speedily become the landlord's problem. The solution depends on the source of the problem and the strength of the lease. Noise can become a problem because of a loud or very drunk clientele, which should respond to a tightening up of security, or because of loud music or loud equipment (e.g., the operation of dishwashers), which may require alterations or changes in operations. Cooking odors can become an issue for neighbors and usually require the installation of an adequate venting system. Vibration can become a problem either through operation of

equipment (such as dishwashers) or the playing of excessively loud music.

Prevention is generally the best solution. The landlord should have the right, at tenant's cost, to have an acoustic engineer review the tenant's plans and specifications for its initial alterations and subsequent alterations to ensure that the tenant installs adequate sound insulation, vibration isolators and other installations designed to minimize or eliminate noise (and the landlord should also include a provision to the effect that the landlord's approval does not relieve the tenant of the obligation to prevent noise and vibrations from emanating from the premises). The landlord also should require the tenant to operate its business in an orderly fashion and to engage such security as is required to operate its business in an orderly fashion. If the building has residential tenants, the landlord should consider whether a restaurant is a good idea to begin with; and/or consider limiting the hours during which the tenant can operate.

Although prevention is the best solution, enforcement is also a critical concern; and the lease should, from the landlord's perspective, include provisions requiring the tenant to eliminate noise, odor and vibrations emanating from the premises, to take immediate steps to mitigate the problem by discontinuing or curtailing the offending activities, and to implement a permanent solution (subject to the alterations clause) within a specified period. Since the landlord may be sued by angry tenants who can't sleep or can't conduct their businesses because of the tenant's restaurant operation, the lease should also contain an indemnification provision broad enough to allow the landlord to recover attorneys' fees and other costs incurred by the landlord as a result of noise, odor and vibration emanating from the premises. Although the tenant will have concern about irrational complaints from other tenants, the reality is that when restaurants create problems, the restaurant tenant often denies the existence of a problem and is reluctant to either change its operations or to install the expensive equipment and sound insulation necessary to correct a very real problem. Accordingly, it is always in the landlord's interest to have the tools to control the problem and the discretion to force the tenant to solve the problem.

Other quality of life issues include pest control, garbage, and trash pickups. The tenant should be required to maintain a contract for regular pest control, and to expand pest-control service at landlord's request. Restaurant tenants are often required to store garbage in refrigerated containers, and to dispose of garbage at specific times and only when the carter is actually picking up the trash.

Most retail leases (and restaurants are no exception) also contain general operating covenants and restrictions intended to ensure that the tenant is acting as a "good citizen." Among other things, the tenant may be prohibited from "going dark," boarding up windows, or abandoning the premises; may be required to keep all glass (including storefronts) clean, to replace broken glass, to maintain the restaurant in good repair and in a clean and sanitary condition, to keep the storefront in good condition and repair and to promptly remove all graffiti. The tenant may also be prohibited from using the sidewalks to advertise (including by handing out flyers and use of "sandwich boards"), broadcasting sound or music outside the premises, permitting any accumulation of rubbish inside the restaurant, obstructing any of the common areas, and/or permitting loitering by its customers, employees, and contractors outside the premises. The tenant may also be required to periodically redecorate and refurbish the restaurant. If the landlord doesn't want dancing or a night club, it should prohibit use as a cabaret or night club, dancing, lap dancing, and possibly music.

Although landlords of mixed use buildings (with some exceptions) do not generally try to control the tenant's menu (except to the extent that the landlord may want to prohibit take-out operations or inappropriate uses), landlords of food courts and

hotel restaurants may want approval rights over menus.

Owner Repairs

Restaurants are usually self-contained operations, with the tenant providing its own cleaning, heat, air conditioning and other services, with the possible exception of (a) structural repairs to structural elements of the building (not necessitated by the actions or negligence of the tenant or any licensee or subtenant) and (b) roof repairs.

Tenant Repairs

Restaurant tenants generally have a higher level of responsibility for repairs than office tenants. The tenant will be responsible for repairing and replacing its HVAC & R equipment, and the landlord should require the tenant to maintain a service contract on all HVAC & R equipment during the entire term of the lease. If odors and fumes have to be vented, the tenant should be required to maintain the flue and any fan motors in good condition and repair, and to maintain a service contract covering the flue and any fans. The tenant will also be required to maintain a grease trap and to keep it and any other grease interceptors clean, as well as to periodically clean any exhaust and hood filters, to regularly clean the sewer and drain pipes serving the premises and to have them roto-rootered on a quarterly or other regular basis. The tenant may also be required to maintain and keep in good repair and free-flowing the common drain lines connecting the tenant's sewer pipes to the street main and the connection to the street main. All elements of the storefront, including the storefront itself, storefront window, and all doors will be the tenant's responsibility; as will the electric system serving the premises and the sprinklers and life-safety system. Since truck deliveries of food and liquor often result in damage to sidewalks, the landlord should make the tenant responsible for sidewalk repairs and replacements, although that may be a subject of negotiation (especially as to structural repairs).

Labor

If the landlord's building is a union building, the landlord may need to require the tenant to use union labor. Accordingly, the tenant should determine whether or not the building is unionized and a labor attorney should be consulted if it is.

Loading Docks

If the building has loading docks, tenant and landlord need to determine if the tenant can use the loading docks, which loading docks it can use and the hours during which they can be used, and tenant's priority of usage (if any).

Subordination, Non-Disturbance, and Attornment

A Subordination, Non-Disturbance and Attornment Agreement ("SNDA") is an agreement granted by a building mortgagee under which the mortgagee agrees that if it forecloses on the building, it will not disturb the tenant's occupancy. It is always desirable, but not always possible, to obtain an SNDA. The tenant needs to weigh, among other things, the risk of foreclosure, the risk its lease will be terminated in a foreclosure, the likelihood it will obtain an SNDA, and the attorneys' fees it will incur in negotiating an SNDA. If the tenant is making a significant investment in the space, the SNDA becomes more important and possibly a critical element of the transaction. If the tenant is thinly capitalized, leasing a small space, or not investing much money, the likelihood of obtaining an SNDA may be low. The importance of an SNDA will vary from lease to lease, and the tenant needs to evaluate how important the SNDA is to the particular transaction.

Insurance and Casualty

The landlord should consult an insurance expert about the kinds of insurance the restaurant tenant should be required to carry. In addition to the garden variety insurance a commercial tenant would be required to maintain, a restaurant tenant is generally required to maintain (a) liquor liability insurance (or dram shop insurance), (b) boiler and machinery insurance (if appropriate), (c) automobile insurance if the tenant owns or regularly leases vehicles (as is likely), (d) personal injury liability including, without limitation, coverage for libel, slander, false arrest and malicious prosecution, (e) check room liability insurance, (f) business interruption insurance (so that the landlord knows that the tenant will be able to survive a business interruption caused by casualty), (g) flood insurance in a flood zone or potential flood zone, (h) possibly key man insurance if the restaurant will be heavily dependent on the efforts or reputation of the restaurateurs, and (i) such other insurance as the landlord may reasonably require (with possibly the caveat that the requirement be customary for restaurants). Tenants are also often asked to maintain plate glass insurance, which may or may not be a practical requirement, depending on the cost of window replacement and the cost of the insurance. If not practical, the tenant should ask the landlord to waive the requirement. An interesting case decided in Colorado suggests that the landlord should consider requiring the tenant to obtain, and should itself obtain, a pollution environmental liability policy covering the actual, alleged, or threatened discharge, seepage, release or escape of pollutants (including any hazardous substances). In *Mountain States Mut. Cas. Co. v. Roinestad*, 296 P.3d 1020 (Colo. 2013), two city employees brought personal injury actions against an insured restaurant owner, alleging the owner's employees negligently poured an excessive amount of cooking grease into a city sewer, clogging the sewer system and causing the plaintiffs to become overwhelmed by poisonous hydrogen sulfide gas while cleaning the clog. The district court found the restaurant owner liable, but also held that the owner's insurance policy did not cover the injuries, as they fell under the policy's "pollution exclusion clause." The court of appeals reversed, holding the injuries were in fact covered by the policy because the terms of the exclusion clause were ambiguous. The Colorado Supreme Court reversed again, holding that the restaurant employees' conduct violated a city ordinance prohibiting the discharge of a pollutant in an amount that creates an obstruction to the sewer flow, that the discharge of the grease amounted to the discharge of a pollutant under the terms of the policy, and that the pollution exclusion clause barred coverage. Putting this in the context of a landlord/tenant relationship, the landlord should consider including pollution coverage in its policy and should also consider requiring the tenant to carry such coverage.

The landlord should also consider the fact that the presence of a restaurant in its building could cause the building's insurance premiums to increase, since restaurants generate both increased risk of accidents (a by-product of serving liquor) and an increased risk of fire, affecting both tort risk and risk of casualty damage. Again, the landlord should consult its insurance advisor about the possibility that its premiums will increase, the potential magnitude of the increase, and what actions should be taken to minimize any premium increase. The landlord should also be sure that its lease contains language:

- Prohibiting the tenant from doing anything or permitting any condition to exist that will conflict with the landlord's policy requirements;
- Requiring the tenant to comply with the recommendations and requirements of landlord's insurer or its underwriter; and
- Requiring the tenant to pay, as additional rent, any increase in the landlord's premiums resulting from the restaurant use or tenant's operations.

The tenant may object to paying increases in the landlord's premiums that don't result from the tenant's specific manner of use of the premises or failure to comply with its lease obligations on the ground that the landlord is receiving a higher rent that should compensate it for, among other things, any premium increases attributable to generic restaurant use. Both landlord and tenant should be willing to include a release and waiver of subrogation clause in the lease so that if a fire occurs, each party looks to its own insurance for compensation. The landlord, however, should ensure that it does not inadvertently assume the cost of replacing the tenant's improvements, fixtures and equipment (which are arguably part of the "premises" and therefore part of the landlord's restoration obligation if the lease requires the landlord to restore the "premises") by (a) requiring the tenant to insure all its furniture, fixtures, and equipment and all of its alterations, additions, installations, and improvements at full replacement cost and (b) stating specifically in the lease that the tenant (and not the landlord) has the obligation to restore same.

If a fire results in a termination of the lease, another question that can arise is who receives the tenant's insurance proceeds. The tenant should be required to restore the restaurant after a fire. However, if the lease is terminated as a result of casualty, the tenant will want to take the insurance proceeds as partial compensation for its lost investment, leaving the landlord with a vacant, severely damaged shell without restaurant improvements (including improvements that the landlord may have funded through free rent and a construction allowance). Accordingly, the landlord may require the tenant to name the landlord as loss payee on the casualty policy, in which event the landlord should agree to pay over the proceeds to tenant for restoration. However, the landlord may also want the right to keep the proceeds if the lease is terminated by reason of casualty. The end result of the negotiation will depend on, among other things, leverage and the size of each party's investment.

Restoration at End of Lease

Building a restaurant is expensive, and so is dismantling one. The tenant generally wants the ability to remove its furniture, appliances and trade fixtures; but does not wish to assume any obligation to remove its alterations or to restore the premises to its former state. If the landlord had its druthers, it would, of course, want the option to require the tenant to either (a) remove its alterations and restore the premises, or (b) leave the alterations in place. Because of the expense involved in removing restaurant alterations and restoring, the tenant should normally strenuously resist assuming any obligation to remove its alterations and improvements. The landlord should, however, make clear that the tenant must remove its signage, trademarked items, and personal property.

CONCLUSION • Restaurant leases are interesting, risky, and sometimes high-stakes transactions. They require care and an unusually high level of due diligence. Although an experienced restaurateur and an experienced landlord understand the risks and the issues, the less experienced may require substantial counseling. And at the end of the day, if all goes well, a good meal will be had by all.

APPENDIX 1

SOME REQUIRED NEW YORK PERMITS

Operating Permit – (NYS Requirement) - An Operating Permit is required to conduct any activity or to use any class of building listed below, including: (1) Manufacturing, storing or handling hazardous materials in quantities exceeding those listed in Tables 2703.1.1(1), 2703.1.1(2), 2703.1.1(3) or 2703.1.1(4), of the Fire Code of New York State (see 19 NYCRR Part 1225); (2) Conducting a hazardous process or activity (including but not limited to, any commercial or industrial operation which produces combustible dust as a byproduct, fruit and crop ripening, and waste handling; (3) Use of pyrotechnic devices in assembly occupancies; (4) Use of a building containing one or more areas of public assembly with an occupant load of 100 persons or more; and (5) Use of a building whose use or occupancy classification has been determined by the local authority as posing a substantial potential hazard to public safety.

Food Service Establishment Permit – (NYS and NYC Requirement) - A Food Service Establishment is a place where food is provided for individual portion service directly to the consumer, whether the food is provided free of charge or sold, and whether the food is consumed on or off the premises. This includes restaurants, employee cafeterias, bakeries, take-outs, pizzerias, night clubs, cabarets, bars, senior centers, emergency food relief organizations, public and non-public schools, or religious, fraternal and charitable organizations. Such establishments are required to obtain a permit from the Department of Health and Mental Hygiene (DOHMH).

Frozen Dessert Permit – (NYC Requirement) - Any place or premises, or any part thereof, where frozen desserts are manufactured, processed, assembled, frozen and stored for distribution or sale at retail directly to the consumer is required to obtain a permit from the Department of Health and Mental Hygiene. This permit is required, in addition to any other requirements for a retail food service operation, where food is sold directly to the consumer. Frozen desserts include, but are not limited to, the following: ice cream, frozen custard, French ice cream, French custard ice cream, artificially sweetened ice milk, fruit sherbet, non-fruit sherbet, granita, water ices, non-fruit water ices, confection frozen without stirring, dairy confection frozen without stirring, manufactured dessert mix, frozen confection, frozen yogurt, freezer made shakes or milk shakes, dietary frozen dessert, "slushies," whipped cream confection and bisque tortoni with any mix used in making such frozen dessert.

Food Handlers Permit – (NYC Requirement) - The Department of Health and Mental Hygiene requires a Food Protection Certificate for supervisors in any food service establishment, including non-retail and temporary food service establishments. The certificate is awarded upon successful completion of a food protection course. A person holding a Food Protection Certificate must be on premises and supervise all food preparation activities during all hours of the establishment's operation. This certification requires applicants to take a 15-hour course (in person or online) and pass an examination (in person only).

Public Assembly Permit (NYC) -- Required if the restaurant has seating capacity for 75 people.

Many other permits may be required. The above is only a partial list.

The above partial list was taken from: Donald M. Bernstein, *How to Buy and Sell a Restaurant*, Program Materials Presented at the City Bar Center for Continuing Legal Education, New York City Bar (April 22, 2015).

RESTAURANT LEASE DUE DILIGENCE CHECKLIST

DUE DILIGENCE	
Liquor License	
☐ Tenant Representations	
☐ Landlord Representations	
☐ Landlord obligation to cooperate	
☐ Any prior liquor license at premises? ☐ Any licenses revoked?	
☐ Location okay?	
☐ Does certificate of occupancy permit restaurant use?	
☐ Local opposition?	
☐ Has liquor license attorney been consulted?	
☐ Contingency or termination right?	
☐ Drop dead date for liquor license?	
☐ Rent payable during contingency period?	
☐ Damages if Tenant fails to comply with its obligations to prosecute liquor license obligation or is not qualified to obtain liquor license	

☐ Compensation if liquor license not granted	
☐ Is broker commission deferred until liquor license issued?	
HVAC	
☐ Adequate?	
☐ Location of unit?	
☐ Consent of landlord needed to location of unit?	
☐ Service contract requirement?	
EXHAUST SYSTEM	
☐ Condition of existing stacks and fans	
☐ Do new or additional stacks need to be installed?	
☐ Where can new stacks be located and will the landlord consent?	
☐ Is access required to other areas of the building to service stacks?	
☐ Service contract requirements?	
ELECTRIC	
☐ Adequate? ☐ If not, landlord consent and cooperation to increase in capacity	
☐ Direct metered?	

SEWER/DRAIN PIPES/GREASE TRAP	
☐ Sewer/drain pipes adequate?	
☐ Connection to sewer main adequate?	
☐ Grease trap adequate?	
☐ Tenant responsibility for its own lines	
☐ Tenant responsibility for common line leading to street main and connection to street main	
WATER	
☐ Metered or submetered?	
☐ If submetered, charged at cost?	
☐ Hot water heating unit?	
ACCESSIBILITY	
☐ Accessibility issues? o Entrance to space o Bathrooms o Other?	
☐ Who indemnifies if entrance not accessible?	
EGRESS	
☐ Does the space meet egress requirement?	

SIGNAGE	
☐ Where will sign be located?	
☐ Landlord consent to sign location	
☐ Landlord pre-approval of sign specifications?	
SIDEWALK CAFÉ	
☐ Legal?	
☐ Landlord cooperation requirement	
☐ Licensing requirement?	
SIDEWALKS	
☐ Condition?	
☐ Tenant responsibility for non-structural repairs	
☐ Tenant responsibility for structural repairs	
GAS	
☐ Is it adequate?	
STEAM	
☐ Is it adequate?	

BROKERAGE (Landlord)	
☐ Commission conditioned on lease execution, payment of security deposit and pre-paid rent due at execution?	
☐ Should commission be conditioned on mortgagee consent?	
☐ Commission conditioned on liquor license?	
☐ Commission conditioned on tenant opening for business to the general public?	