



LEASE AGREEMENTS IN SHOPPING CENTRES – THE MOST DISPUTABLE CLAUSES

June 2016



Dear Sirs,

A standard lease agreement contains about 30 pages and negotiations of the agreement may last from several to over one hundred hours. The talks usually come to a standstill when the parties need to agree on difficult issues, and the results of prolonged negotiations may be very severe and measurable to both parties. They may pose a risk of failing to meet the deadlines agreed by the landlords with the banks for project commercialisation thresholds, they may extend the time spent by the parties on negotiations, and they may also affect an increase in the costs of the whole process. In order to improve negotiations, increase their effectiveness and reduce their duration, we decided to investigate which provisions in the lease agreements are the most difficult and most time-consuming.

Two years ago, basing on our experiences and talks with the representatives of the industry, we identified the difficult clauses and using an online questionnaire together with the Polish Council of Shopping Centres we verified whether experiences of other landlords and tenants confirmed our observations. We decided to repeat the survey after two years and check whether there were any changes with respect to identification of the clauses as difficult. The commercial area market keeps evolving and maturing, but is a period of two years a sufficient time for the negotiations process to become standardised and for the duration of the negotiations to become shorter?

I would like to encourage you to read the results of this year's edition of the survey. In order to present the changes that took place in the perception of difficult and time-consuming clauses, we compared the results with the responses from the previous survey. We also asked market experts representing all parties to the negotiations to comment on the results. I hope that the effect of our joint considerations will help improve the effectiveness of the work on negotiations of lease agreements.

Hope you will enjoy our report!

Sławomir Lisiecki
Partner / Legal Advisor
Galt Law Firm



Dear Sirs,

The Polish shopping centre market has reached full maturity. We have almost 500 shopping centres, over 2000 brands and shopping networks and several hundred other entities providing services for the industry. On the one hand, the figures are a reason to be proud, but on the other hand, such a large number of interests and varied parties may lead to many disputes or conflict generating situations.

However, the market maturity can be defined not only through figures but also by looking at the method of operation, the standards applied or attempts to solve problems amicably and handling of difficult situations. Publications prepared a few years ago, such as the Good Practices Code of the Polish Council of Shopping Centres or the current surveys developed together by the PCSC and the Galt Legal Firm, contribute to preventing the often difficult issues from giving rise to a conflict between the parties and

to making them only a matter of fair business negotiations in which each of the parties understands the needs and intentions of their partner.

Lease agreements are one of the fundamental documents on which the commercial property industry and operations of the most important entities on the market are based. When preparing the results of the survey we tried to define the most sensitive contractual provisions and clauses that evoked most emotion or even caused a delay in the process of finalisation of an agreement between the parties.

I hope that this publication will prove to be a valuable source of information and the knowledge gathered in this report will make negotiations of each new agreement for lease of a commercial area faster and simpler, both on the part of the landlords and tenants.

Hope the reading will be productive!

Radosław Knap
CEO
Polish Council of Shopping Centres



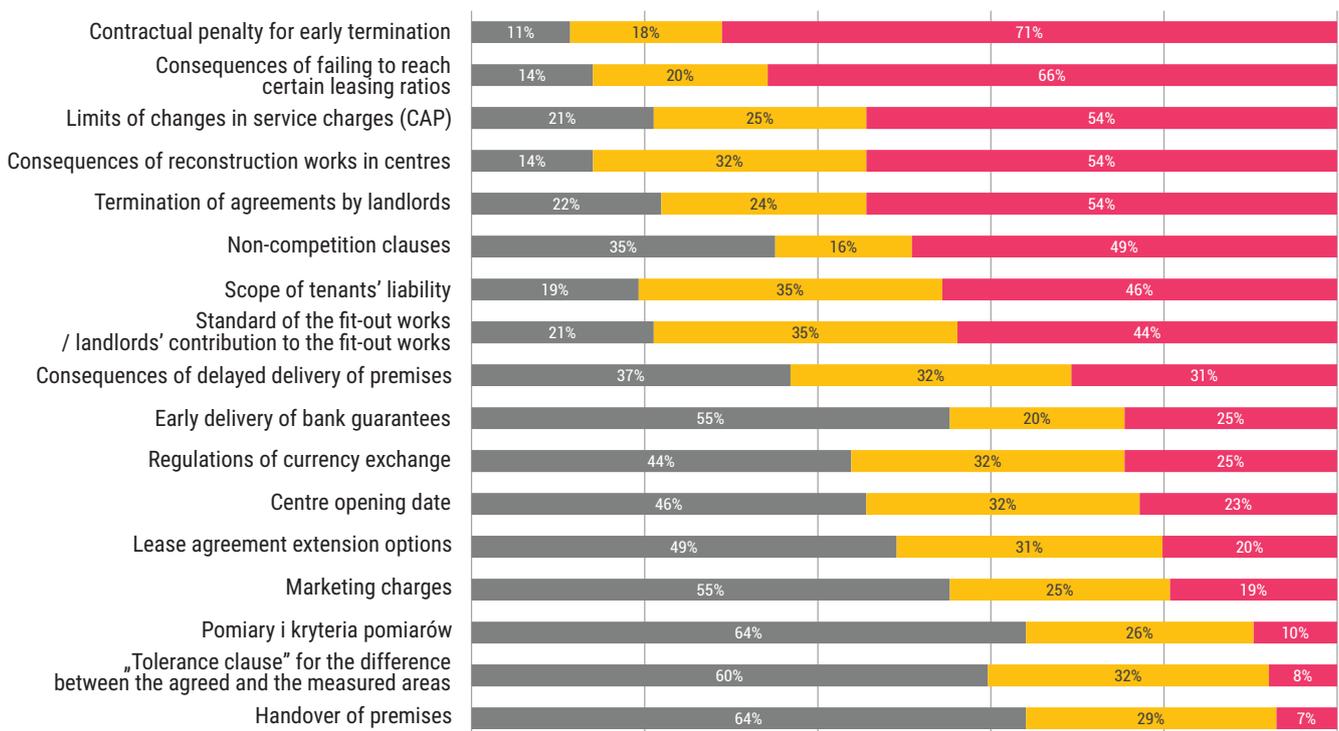
**POLSKA RADA
CENTRÓW HANDLOWYCH**
POLISH COUNCIL
OF SHOPPING CENTRES

1. DISPUTABLE ISSUES IN LEASE AGREEMENTS – RESULTS OF A 2016 QUESTIONNAIRE SURVEY

Negotiations of lease agreements are often time-consuming. Sometimes they „get stuck” when the parties come to agree difficult contractual issues. Prolonged negotiations may pose a risk of failing to meet the deadlines agreed by the landlords with the banks (for project commercialisation thresholds) and they may extend the time spent by the landlords’ commercialisation teams on negotiations (and lead to a cost increase). In the case of facilities that are already operational they may also have a negative impact on the landlords’ financial flows. The objective of this survey was to identify the clauses in agreements for lease in commercial buildings that take the most time in the negotiations process. Based on our experiences and talks with the representatives of the industry, we have identified a catalogue of „difficult clauses”. Next, we verified our observations using an online questionnaire.

We present below the results developed on the basis of the responses given by the respondents in the questionnaire survey.

DISPUTABLE ISSUES IN LEASE AGREEMENTS 2016



Difficulty level in negotiations

- easy to agree, rather easy
- moderate / neither easy, nor difficult
- rather difficult, difficult to agree



Sławomir Lisiecki
Partner / Legal Advisor
Galt Law Firm

The clause concerning contractual penalties in case of termination of the lease is the inglorious „winner” of this year’s survey, that is the provision that was most frequently identified as a difficult one to agree. The result is not surprising to anyone who knows the market reality – negotiations during which this is not one of the hottest issues rarely happen, even though it is crucial to the functioning of all the persons involved. The landlord’s perspective: *I have built/bought a shopping centre, I need to manage it all, I am building the value of the facilities based on stable leases, so if I lose a tenant I need to be compensated for that*, is inevitably confronted with the tenant’s perspective: *I lease premises, I organise the team, goods and store, and if there are problems, I will still have to pay a fortune to the owner*. Is it possible to reconcile these positions? I think it is, after a closer look at some risks which the owners are now trying to limit by negotiating the amount of contractual penalties involved in termination. One of their concerns is the waste of the „investment made in the lease” (the rent discounts granted and any outlays for fit-out works). Therefore governing the compensation for this investment, separate from contractual penalties, may be an argument for taking a more flexible position, especially as in case of a dispute, the penalties awarded to the owner may be in practice reduced by the court. Such regulation could have the form of the tenant’s obligation to return the „non-amortised” incentives obtained from the landlord – in proportion to the actual duration of the lease. If the value of the incentives was 100, the planned lease term was 5 years and the lease was terminated after 3 years, then with this regulation in place, the tenant would reimburse the amount of 40 ($100 \times 2/5 = 40$). With such arrangement, the contractual penalty would actually have the function of compensation for the need to search for a new tenant and the landlord’s acceptance of a vacancy, but since the principles of reimbursement of „solid” (already spent) money were already agreed in line with different principles, there is a higher chance of reaching a compromise easier (and sooner).

2. DISPUTABLE CLAUSES IN LEASE AGREEMENTS – 2014 VS. 2016

Compared to 2014, the average percentage of respondents who considered the clauses in lease agreements in question to be difficult or very difficult in negotiations has increased. There have also been significant changes in the perception of the difficulty of particular clauses in lease agreements. The table below shows TOP 5 most difficult clauses indicated by respondents of the survey in 2014 and 2016.

TOP 5 MOST DIFFICULT CLAUSES IN 2014	TOP 5 MOST DIFFICULT CLAUSES IN 2016
1 Consequences of failing to reach certain leasing ratios – 72%	Contractual penalty for early termination – 71%
2 Consequences of reconstruction works in centres – 66%	Consequences of failing to reach certain leasing ratios – 66%
3 Contractual penalty for early termination – 60%	Limits of changes in service charges (CAP) – 54%
4 Limits of changes in service charges (CAP) – 51%	Termination of agreements by landlords – 54%
5 Standard of the fit-out works – 42%	Consequences of reconstruction works in centres – 54%

DISPUTABLE CLAUSES IN LEASE AGREEMENTS - indication of difficulties, 2014 vs. 2016

	Value in %		Ranking	
	2014	2016	2014	2016
Contractual penalty for early termination	60%	71%	3	1
Consequences of failing to reach certain leasing ratios	72%	66%	1	2
Limits of changes in service charges (CAP)	51%	54%	4	3
Consequences of reconstruction works in centres	66%	54%	2	3
Termination of agreements by landlords	26%	54%	8	3
Non-competition clauses	28%	49%	7	4
Scope of tenants' liability	26%	46%	8	5
Standard of the fit-out works / landlords' contribution to the fit-out works	42%	44%	5	6
Consequences of delayed delivery of premises	34%	31%	6	7
Early delivery of bank guarantees	26%	25%	8	8
Regulations of currency exchange	-	25%	-	8
Centre opening date	15%	23%	10	9
Lease agreement extension options	21%	20%	9	10
Marketing charges	-	19%	-	11
Measurements and measurement criteria	6%	10%	12	12
"Tolerance clause" for the difference between the agreed and the measured areas	13%	8%	11	13
Handover of premises	4%	7%	13	14

The issue of **contractual penalties in case of agreement termination** proved to be definitely the most problematic one in this survey – as many as 71% of respondents considered it to be rather or very difficult and time-consuming in lease negotiations. It is as many as 11 pp more than in the previous edition of the survey. This means that determination of the consequences of failing to reach particular commercialisation thresholds is no longer considered to be the most problematic issue (66% of responses compared to 72% in 2014).

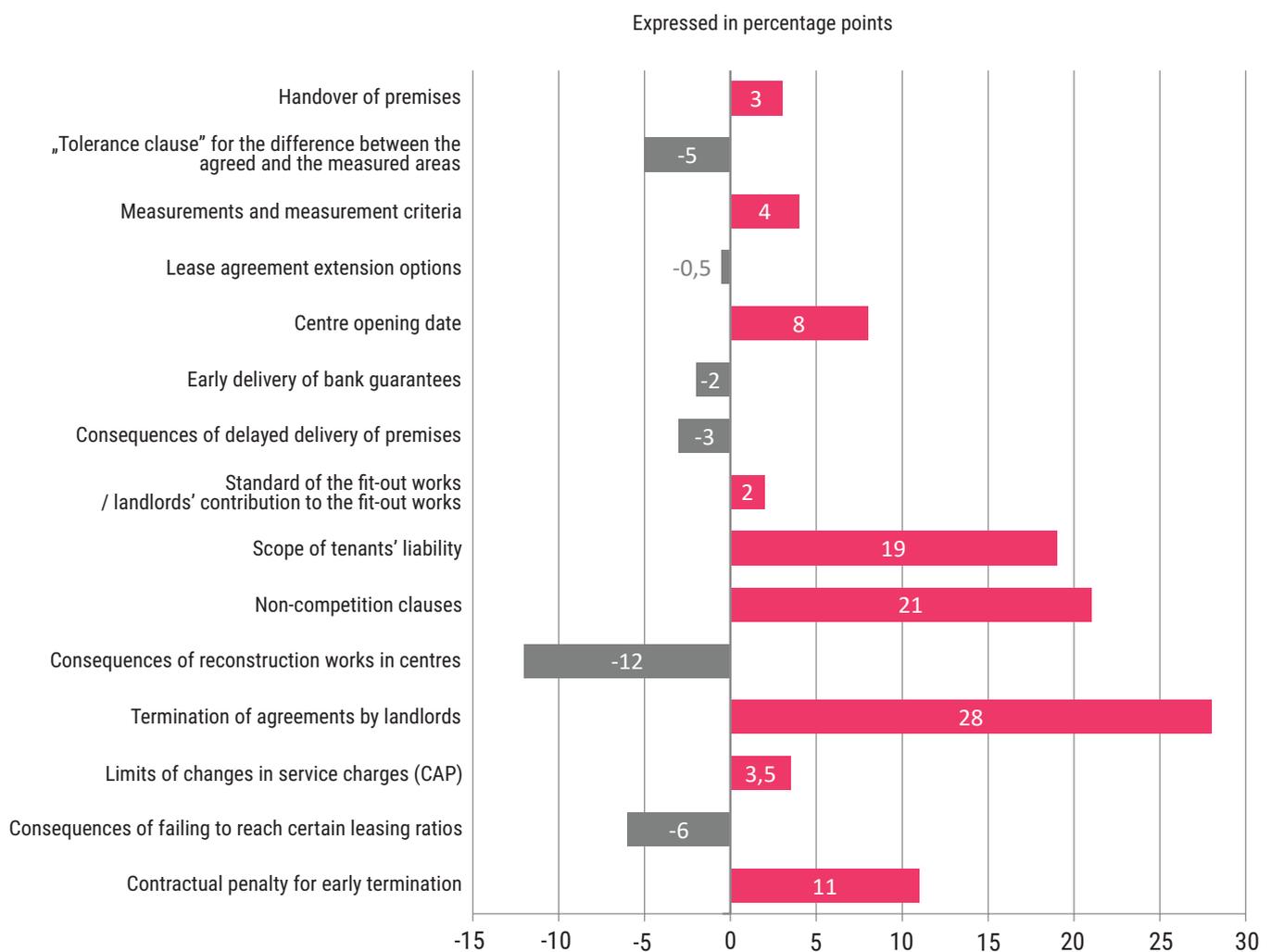
Equal third place in terms of difficulty in negotiations of lease agreements, with the result of 54%, belongs to clauses concerning the principles of settling **service charges** (nearly the same number of respondents assessed them as difficult in 2014), consequences of **works related to reconstruction of the centre** (drop by as many as 12 pp) and provisions **concerning termination of agreements by landlords**.

This last issue in particular is becoming more and more important – the number of respondents that considered it to be time-consuming and difficult to agree was now higher than two years ago by as many as 28 pp.

There have been considerable changes over the last two years in the perception of the issue of the provisions concerning **non-compete clauses** and the scope of **tenants' liability** – the number of respondents who considered them to be rather or very difficult and time-consuming was higher by 20 pp compared to 2014, which gives the issues the fourth and fifth place on the current list. It is worthwhile to note that there were exceptionally few (16%) neutral responses, that is assessments that the difficulty is moderate, among the responses to the question about the non-compete clauses, which may show that the importance of the issue varies considerably depending on other factors.

Invariably, over 40% of respondents dealing with lease consider it difficult to negotiate the clauses concerning **fit-out**. Still a bit more than 30% of respondents see a problem in negotiations of consequences of any **delays in handover of premises**. Respondents' indications concerning the remaining clauses, which were considered to be easier to negotiate, have not changed considerably compared to the previous survey in 2014. New items on the list (that is items introduced to the survey in 2016) proved quite problematic: **the rent currency exchange formula** may give rise to doubts among 25% of respondents, while 19% of them consider issues related to **marketing fees** to be difficult.

CHANGE IN THE PERCEPTION OF CLAUSES “difficult to agree” and “rather difficult” for particular clauses in 2016 vs. 2014





Grzegorz Latała
Commercialisation
Director / Board Member
Mayland Real Estate

The perception of the clause concerning consequences of works related to reconstruction of the centre as a difficult one has dropped considerably compared to 2014. What may be the reason for that? Several shopping centres have been extended in the recent years on the commercial property market, including Bielany Wrocławskie, Riviera Centre in Gdynia. Generally, the extensions were carried out efficiently and without much nuisance to the tenants, which the market noted. Undoubtedly, this affects a change in the perception of the contractual provisions concerning works related to reconstruction of a centre. One should not forget, however, that the basic criterion for a tenant who agrees to such a provision is the expected position of the shopping centre after the extension. If tenants anticipate that the extended centre will become more attractive to the customer, will achieve a dominant position on the local market and consequently the stores will generate higher turnovers, then they are more willing to accept such provisions.

The owner of a shopping centre also needs to have, to some extent, freedom to take the decision to extend or reconstruct their facilities. Tenants cannot decide on and block such actions because it is a value added to them in a long-term perspective. More and more often extensions consist in expansion of the food court and entertainment part and not only in addition of clothes shops. Mature tenants have a good understanding of such operations.

3. LANDLORDS VS. TENANTS

As you can see in the chart below, assessment by the two parties to negotiations of lease agreements, i.e. landlords and tenants, differ with respect to particular clauses. Most of the clauses included in this survey turned out to be more problematic for tenants than to landlords. Landlords indicated only four clauses which they considered to be more difficult in negotiations than tenants – it constitutes 23% of the all researched clauses. It regards contractual penalties for early termination, service charges (the so-called CAP's), as well as, to a small degree, lease agreement extension options and measurements and measurement criteria.

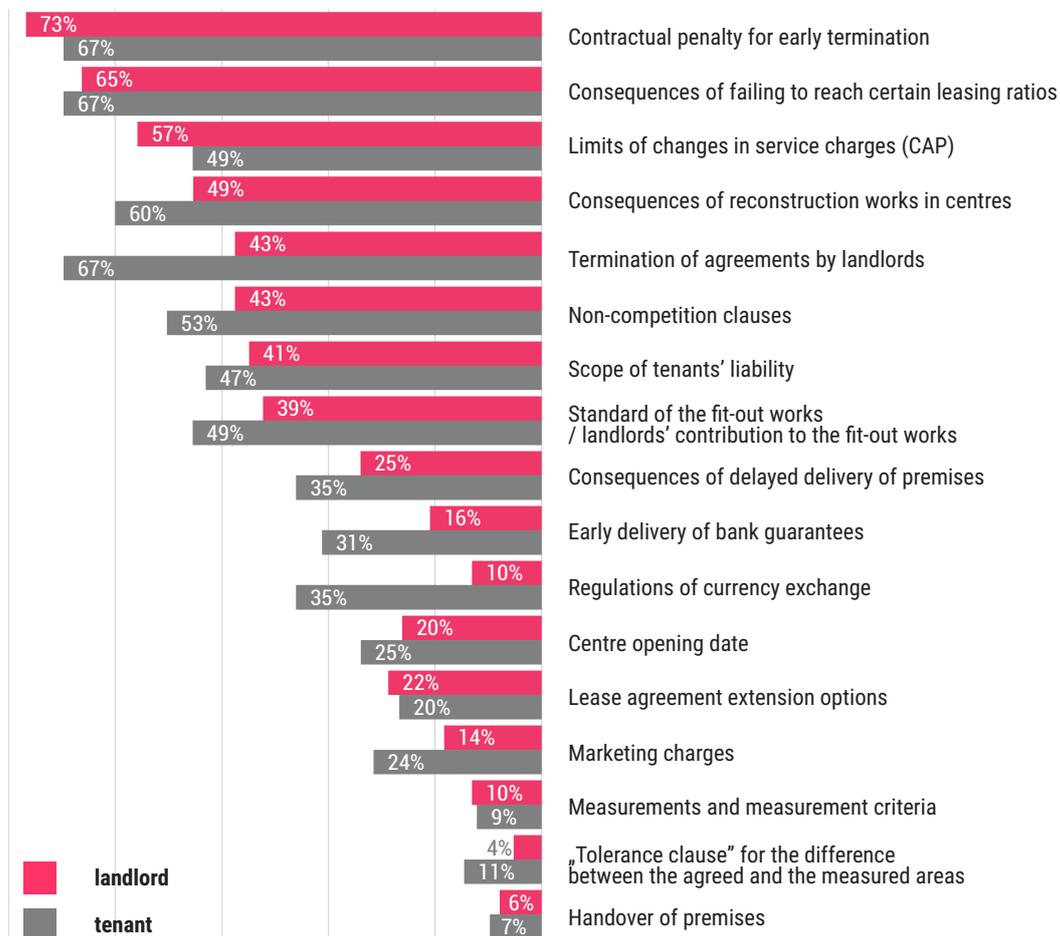


Małgorzata Laskowska
Associate Director
Retail Agency, CBRE

Lease agreements are supposed to give tenants an opportunity to run business in a stable manner over the course of many years and to provide landlords with advantageous funding of the project. Both parties have an interest in beneficial provisions in agreements, which is why negotiations of the agreements are often a long-term and complex process. It is a disputed issue between tenants and landlords who incurs a higher risk of running business in shopping centres and as such, requires more protection in the lease agreement. Eventually, the version of the agreement depends on economic conditions, operating strategy and financial plans of the parties.

Many experts consider the Polish shopping centre market to be mature. We have nearly twenty years of intensive development and accumulation of experience behind us. Provisions of lease agreements have evolved in order to reflect the changing market conditions, the scopes of the landlords' and tenants' rights and obligations have changed, centre maintenance services have been extended and damages have been governed. It seems that lease agreements should give rise to less controversy in the years to follow but it all depends on issues subject to negotiations, effectiveness of negotiators/lawyers of both parties, negotiation and financial capacity or willingness to compromise.

LANDLORDS VS. TENANTS – comparison of sum of „difficult” and „very difficult” responses



An asymmetry of standpoints regarding perception of difficulty in lease negotiations between landlords and tenants is most noticeable with respect to the three researched issues. The largest discrepancies relate to termination of agreements and rent currency exchange formula. Almost 70% of tenants and slightly more than 40% of landlords indicated difficulties in negotiations of clauses relating to lease termination. Whereas regulations of currency exchange were indicated as difficult and time-consuming by 35% of tenants and only 10% of landlords. The last clause regards early delivery of bank guarantees. It is problematic for 31% of landlords and only 16% of tenants.



Elena Wawrzeńnik
Expansion Manager
Eastern Europe (PL, CZ,
SK), Tally Weijl Polska

From our perspective, compared to the situation from a few years ago, the provisions in lease agreements have become stricter in a few items concerning, among others, modernisation of the facilities, the issue of development of the common areas and the landlords' obligations.

Now agreements include very extensive clauses concerning reconstruction of a shopping centre and even though modernisation of a centre is part of both parties' interest, proposed provisions in lease agreement can be one-sided and anticipate that the landlord has a right to carry out onerous works without compensating the tenant for their losses and include mandatory relocation, loss of non-amortised fixed assets or early termination of the agreement. From the tenant's perspective, such provisions are problematic for a few reasons. The time and duration of the works is determined by the landlord and often does not account e.g. for dates of ordering collections. Reconstruction of a centre often involves a drop in the number of visitors, and consequently, in the turnover of the store. Modernisation works often generate additional costs on the tenant's part, such as protection of the premises from dust or ordering of extra cleaning services. There also arise issues that are related to possible changes in the centre tenant mix or change in the location of the store, adjacent premises or even the distance from the escalator. From the tenant's point of view, such changes may pose considerable difficulties and it is not surprising that such clauses give rise to controversy and are more time-consuming during the negotiations.

Currently agreements more and more often include also provisions making it possible for the landlord to develop the common areas at their own discretion, which in practice may mean partial or total reduction in the visibility of the premises and consequently – lower turnover. Also clauses that release the landlord from any liability for commercial results of the shopping centre may be difficult to negotiate – the number of visitors, tenant mix or effectiveness of marketing activities.

4. E-COMMERCE AND NEGOTIATIONS OF LEASE AGREEMENTS

The last issue raised in the survey pertained to the „omnichannel”. Participants of the survey were asked how e-commerce may affect issues related to lease of area in shopping centres.

40% of representatives of landlords in the survey gave a positive answer to the question: „Do you consider any form of protection introduced in lease agreements against the tenants' rechannelling the turnovers from the shopping centre to e-commerce? If so, what is it?”.

The issue will undoubtedly become more important during signing of lease agreements, as many as 67% of representatives of tenants declared that their company „run (or plan to run) online sale”. However, only 5% of them gave a positive answer to the question: „Are you planning to reduce the area of stationary stores in relation to the launch of online sales?”.

METHODOLOGY:

The report was developed on the basis of data gathered in a questionnaire survey conducted by the Galt Law Firm and the Polish Council of Shopping Centres at the turn of March and April 2016. The survey was conducted with the Computer Assisted Web Interview method. The survey participants included persons representing landlords, tenants and other entities involved in negotiation of lease agreements in their everyday operations.

The survey questionnaire was developed by the Galt Law Firm in cooperation with the Polish Council of Shopping Centres based on data held in their own databases, interviews with representatives of the industry and generally available online resources.

114 fully completed questionnaires were collected in total. The structure of respondents according to group categories was as follows:

- 48% – representatives of tenants leasing premises in shopping centres,
- 45% – representatives of landlords,
- 7% of respondents were from the „Other” category. The following unique entries were made in the „Other” category: agency / both sides of the market / intermediary / law firm.

Similarly equal proportions were revealed in the structure of the size of the companies (44% of representatives of large and medium companies each, only 12% – small companies), as well as with respect to the ownership structure of the companies: 41% with Polish capital and 48% with foreign capital, the remaining 11% were companies with mixed capital.

Respondents surveyed on the tenants’ side represented categories: Fashion (40%) and Catering (18%); fewer (less than 10% of the entire group of tenants): Health and Beauty, Services, Food, Specialist Products (multimedia, household appliances, jewellery etc.) and Entertainment. The tenants’ group also included a few representatives of superstores (supermarkets/hypermarkets, DIY).

A vast majority of respondents were persons on senior managerial positions in their companies (directors: 37%, managers: 48%), the remaining respondents were working as specialists (15%).

ABOUT GALT:



27 PEOPLE
IN THE TEAM

6 attorneys-at-law **3** advocates
2 tax advisors **1** insolvency practitioner

4 AREAS OF
SPECIALIZATION

Law | Tax | Accounting | Restructuring and Bankruptcy

6 YEARS
ON THE MARKET



443
CLIENTS

COOPERATION WITH **5**
PRESTIGIOUS ASSOCIATIONS

- International Business law Consortium
- INSOL Europe
- International Facility Management Association
- Women in Real Estate
- Polish Council of Shopping Centres

22 INVESTMENTS

retail | warehouse | office
comprehensive legal assistance, of the
total area of **178 thousand sq. m.** and with
EUR **186 million** value of rents

SCOPE OF ACTIVITIES FOR SHOPPING CENTRES:

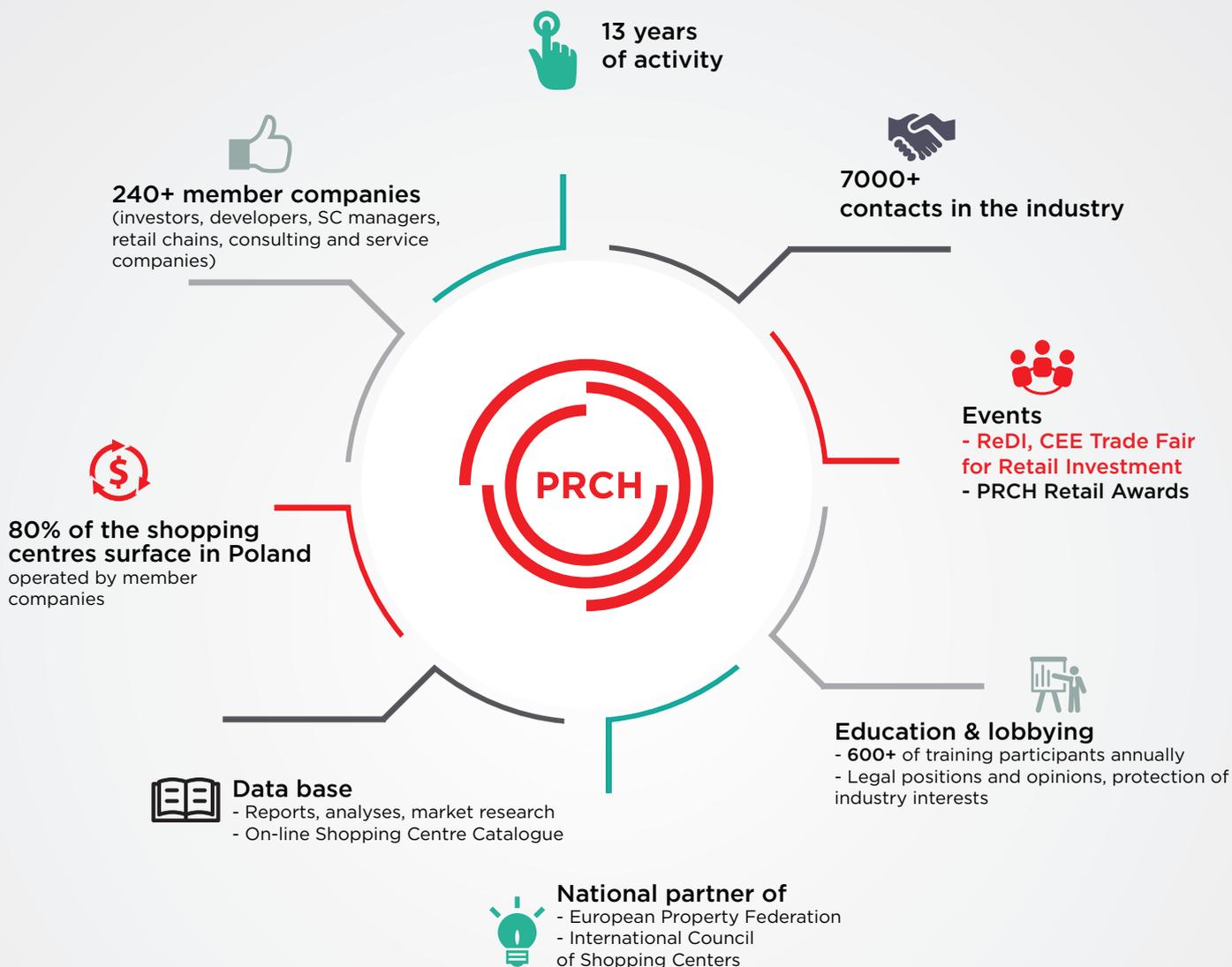
- lease agreements
- support in the field of "asset management"
- fee charges recovery (vindication)

ABOUT PRCH:



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