



SHOPPING CENTER LEGAL UPDATE

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“We’re from the Government and We’re Here to Help You (Be Green and Accessible)”: Current Regulatory Issues in Shopping Center Operations

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Many consider governmental assistance to be a scary—if well-intentioned—message. This article will discuss trending sustainability and accessibility mandates affecting shopping center operations, using the experiences of the Macerich Development team to illustrate. Whether or not governmental actions are helpful, it is important that shopping center operators and merchants be aware of what is already happening and likely to happen soon.

The Growing Legislation for Energy Benchmarking Disclosure

Several states and cities now require “benchmarking disclosure.” For specific information, visit Buildingrating.com, which is produced by The Institute of Market Transformation, a Washington D.C.-based nonprofit organization promoting energy efficiency, green building and environmental protection. The website provides a chart and other useful information about the jurisdictions that require benchmarking disclosure.

Macerich operates in the following states and municipalities with energy disclosure requirements: Chicago, California, New York City and Washington State. Some of these jurisdictions require energy disclosure annually; others require disclosure when there is a sale or lease of an entire building. The size of the buildings covered varies by jurisdiction. In California, 10,000 square foot buildings currently are required to disclose their energy efficiency; the requirement will go down to 5,000 sf in January 2016.

Part of the disclosure involves posting the energy information on Energy Star Portfolio Manager software, which allows access by the government and the public. Usually, the disclosure applies to electricity, gas and oil usage. New York City requests water usage as well. NYC also recently passed a requirement that, every 10 years, each covered building must go through an energy audit and retro-commissioning—which is likely to be expensive. So far, Macerich indicates that the energy benchmarking requirements are neither overly burdensome nor beneficial to anyone. The promise of energy benchmarking disclosure is that as more information becomes available, it will affect the marketplace in ways that encourage energy efficiency.

Electric Vehicle Legislation

There are apparently no current laws affecting existing shopping centers that require electric vehicle (EV) charging stations on commercial property. However, that is something to watch for in the future. The State of California recently tried to pass a law that included a requirement for EV charging stations on properties with more than 50 spaces. Although the law did not pass with this requirement, the initial proposal may signal the trend of future legislation around the country. California introduced a bill mandating installation of EV charging stations, but it was significantly amended to address industry concerns before it passed into law in September 2014.

The focus of the bill now is to give a tenant the ability to install an EV charging station when the tenant is willing to pay for all costs associated with, and assume all liability related to, installation, maintenance, operation and removal of the unit. The law applies to multi-family residential and commercial buildings on properties with more than 50 parking spaces. The proposed law initially received a substantial amount of press, mostly because it then was to require 1 percent of the parking spaces to have EV charging stations.

Incentives for Solar Energy and Other Sustainable Energy

While the use of solar energy or any other energy from other sustainable sources is not mandated anywhere (to the author’s knowledge), government incentives are the major factor that currently persuades developers to invest in solar power or other renewables. A website operated by the North Carolina State University Clean Energy Technology Center may be the most comprehensive source of information on incentives and policies that support renewables and energy efficiency in the United States: www.dsireusa.org.

Macerich believes that investment in sustainable energy is important for a number of reasons, including the company’s desire to contain energy costs and customers’ desires for the responsible operation of shopping centers. Accordingly, a few years ago, Macerich embarked on an ambitious plan to add solar energy systems to several of its properties that have sufficient exposed areas to support panels. In addition to the need for appropriate available surface area for the solar panels, available federal credits and state subsidies were necessary to make these efforts worthwhile.

There are currently seven centers with solar panel systems providing electricity (four in California, two in Colorado and one in Arizona). Another three centers are expected by the end of 2015 and two more in 2016. While likely best-suited in the Sunbelt, Macerich is building a system at one center on the East Coast—Danbury Mall (“Danbury”) in Danbury, Connecticut.

Some statistics on the Macerich centers already are available:

- On average, 42% of the electricity used by the developer/manager of the centers mentioned above is produced by solar panels. The highest is 84%; the lowest is 22%. In centers where tenants are separately metered to the public utility, the panels make much less of an overall impact. In those centers, the impact of these solar panels is between 7% and 10% of the total electricity used at that center. In addition, the ability to produce a high percentage impact is limited by how much surface area is available to install the solar panels and, of course, the amount of sunlight that will be hitting those panels. While helpful, it does not seem that solar alone will be the answer to the projected increase in energy costs.
- As another example of energy to be generated from a renewable source, Macerich installed a “fuel cell” at Danbury. A fuel cell uses natural gas (or another type of fuel) and oxygen (or another oxidizing agent) to create a chemical reaction that releases the chemical energy from the fuel to produce electricity. The by-products of the process are heat and water. This process is much more efficient than typical electricity production methods—about 60% compared to the 33% efficiency of a typical coal plant.
- The fuel cell program at Danbury is set up through a power purchasing agreement with the local utility company, whereby the utility pays capital expenses and the center purchases the generated electricity from the utility at a competitive rate. Thus, Macerich did not invest any capital costs for the project.

The fuel cell will produce approximately 37.7% of Danbury’s annual power. Combined with the solar project, Danbury will receive 46.2% of its power requirements from renewable sources. The fuel cell has been running since June of 2014; the solar panels are planned to be operational by May 2015. Macerich’s experience shows that government incentives have been a necessary component of the cost effectiveness of investing in sustainable alternate energy systems.

Chain-Store Regulation Case Study: San Francisco ‘Formula Retail’ Regulation

Many municipalities, mostly small towns whose economies depend on tourism, have passed laws restricting construction of chain stores. The largest city to do so is San Francisco (“SF”). In 2006, SF enacted the most influential anti-chain legislation in the United States. Section 703.3 of the SF Planning Code mandates specific controls on “formula retail,” a term the law uses to define chain stores. The SF Planning Code definition of formula retail relates to standardized merchandise, façade, décor, color scheme, signage and other aspects of the ways a retailer brands its identity.

It seems especially significant that San Francisco, a major city, is regulating commerce this way. The SF law has evolved. When first adopted in 2004 by the SF Board of Supervisors, the city ordinance offered neighborhoods options ranging from notification letters mailed to nearby residents upon a chain store’s arrival to a total ban on chain stores in their neighborhood. In 2006, voters chose to implement a more widespread solution: conditional use authorizations. Every national retailer that wants to move into one of SF’s small-scale commercial streets must be approved by the SF Planning Commission. Today, hundreds of blocks require chain stores to obtain authorization, while dozens of other blocks still operate under a chain-store ban.

The SF Planning Commission is still involved in economic studies to evaluate the effects of its chain-store controls. Shopping center operators and merchants might want to follow closely what happens in SF, as that may set a precedent for other major cities.

California Zero Net Energy Goals

In 2008, the California Public Utilities Commission published a Strategic Plan (“Plan”), setting what became known as the Big Bold Energy Efficiency Standards. According to the Plan, all new residential construction will be “zero net energy” by 2020 and all new commercial construction will be zero net energy by 2030. These requirements promise to reshape the shopping center and larger construction industry in significant ways—and not just in California.

The definition of “zero net energy” is still a work in process. Current working definitions in California and other industry forums contemplate the following requirements:

- The energy produced by onsite renewable energy systems must at least equal the amount of energy used by the building.
- The project must have a neutral or net positive interaction with the “grid,” and
- The building’s embodied energy must be considered: Embodied energy is the total energy required for the extraction, processing, manufacture and delivery of building materials to the building site.

The California Energy Commission and the California Public Utilities Commission will be attempting to finalize a definition in the next few years, as the State gets ready for the Big Bold Energy Efficiency Standards intended to go into effect in 2020 and 2030. We can expect the government to continue its focus on incentivizing and even forcing building operators not to use more energy than a building produces; such focus will certainly have a significant effect on shopping center operations.

Regulation of Plastic Bags

In 2007, San Francisco enacted the first United States plastic bag ban, which was followed by bans in Los Angeles, Seattle, Portland, Aspen, Chicago, Austin, four islands in Hawaii and parts of North Carolina, among other municipalities. California, as of September 30, 2014, became the first state in the nation to ban single-use plastic bags at grocery stores starting July 2015, and at convenience stores and pharmacies starting in 2016. Massachusetts, Pennsylvania, New York and New Jersey are all considering imposing a tax on plastic bags, which customers would have to pay, according to the National Conference of State Legislatures. Rhode Island has introduced legislation that would require stores to recycle plastic bags. Proponents of plastic bag bans on retail businesses claim that such a ban will reduce both the amount of waste entering landfills and litter on streets. It seems likely that plastic bag regulation, as well as other governmental action to control activities deemed to burden landfills, create litter or otherwise harm the environment, will increase over time.

Segways and Other Power-Driven Mobility Devices

The Americans with Disabilities Act (“ADA”) prohibits discrimination against people with disabilities in public accommodations. The ADA addresses two types of mobility devices: (1) wheelchairs and manually powered mobility aids and (2) other power-driven mobility devices (“OPDMDs”). An OPDMD is any mobility device powered by batteries, fuel or other engines—whether or not designed primarily for use by individuals with mobility disabilities—that is used by individuals with mobility disabilities for locomotion.

Recently, the Department of Justice (“DOJ”) issued guidance on when public accommodations must allow OPDMDs. The DOJ publication on Wheelchairs, Mobility Aids, and Other Power-Driven Mobility Devices is available at www.ada.gov/opdmd.htm; the publication states that public accommodations such as shopping malls will have to allow the use of OPDMDs (including Segways) in the vast majority of cases.

Based on regulatory guidance, public accommodations must make reasonable modifications to their policies, practices and procedures to permit the use of OPDMDs by individuals with mobility disabilities, unless the public accommodations can demonstrate that such devices cannot be operated in accordance with legitimate safety concerns. Policies may include limiting operation to the speed of pedestrian traffic and may impose reasonable restrictions (e.g., time of day and year and permitted areas).

There is a five-factor test to assess legitimate safety concerns:

1. The type, size, weight, dimensions and speed of the device,
2. The facility’s pedestrian traffic,
3. The facility’s design and operational characteristics,
4. Whether legitimate safety requirements can be established to permit the safe operation of an OPDMD in that facility, and
5. Whether use of the OPDMD creates a substantial environmental harm or conflicts with federal land management laws.

Shopping center and retail store managers should keep in mind that the DOJ is in favor of OPDMDs. Since the DOJ currently views Segways as the least obtrusive OPDMD, it may be a best practice to allow Segway use by disabled persons in shopping centers and retail stores—except to the extent there is a substantial reason that they cannot be safely used.

It should be noted that the Walt Disney World Company faced, and recently settled, several widely publicized lawsuits seeking to force Disney to allow Segway use at its theme parks under the ADA and other laws. Disney incurred significant legal expense. At times, Disney argued that its permission to use OPDMDs—and its facilitation of wheelchairs, scooters and its own stand-up mobility device as alternate mobility devices—should be sufficient for the plaintiffs’ accessibility to its parks. For better or worse, the Disney litigation did not make clear whether or not Segways can be banned at amusement parks or other venues. For instance, the issue of safety was never litigated. Consequently, shopping center operators have received little guidance to suggest that a ban on Segways might be a cost-effective policy. The shopping center industry should carefully monitor future litigation related to disabled customers’ efforts to use Segways and other OPMDs.

Service Animals

Under the ADA, businesses that serve the public generally must allow service animals to accompany people with disabilities in all areas where the public is normally allowed to go. The DOJ publication on service animals is available at http://www.ada.gov/service_animals_2010.htm.

Except in a limited number of states that expand the federal definition, service animals are limited to dogs and miniature horses. Under ADA Title III, a service animal must be individually trained to perform tasks for individuals with disabilities. In most states, retail venue management may ask an individual with a dog (or miniature horse) only the following two questions:

1. Do you need this animal because of a disability?
2. What work or tasks has the animal been trained to perform?

If the person says Yes to #1 and can identify the work or tasks per #2, it is prudent to treat the dog or miniature horse as a service animal. While some level of verification might be appropriate, Macerich currently is following a policy of NOT asking further questions about the disability. Also, Macerich does not ask for a demonstration of the work or tasks. Those policies are, of course, subject to change.

While in a shopping center or retail store, the service animal must be on a leash, unless that interferes with the service animal's work or if the individual's disability prevents using the leash. Where the "no leash" exception applies, the disabled person must be able to maintain control of the animal through voice, signal or other effective controls.

State law should also be reviewed to assure that animals other than dogs and miniature horses can be service animals. Macerich operates centers in Illinois, Iowa and Washington, where the definition of a service animal is not limited to dogs and miniature horses. In those states, the same line of questioning as noted above is applied with regard to any individual seeking to bring an animal into a shopping center.

Macerich, as well as others in our industry, will certainly want to watch for any developments in the service animal area of accessibility law; however, in the meantime the company believes it is best practice to follow the service animal policy described above.

California's New Law to Curb Drive-By Lawsuits

Recent laws enacted in California, which are intended to address perceived "drive by lawsuit" abuse, warrant the attention of shopping center operators and merchants.

The term "drive-by lawsuit" refers to lawsuits filed by plaintiffs' attorneys who work with disabled clients and individuals who are investigating drive-by businesses to observe instances of ADA non-compliance. If found, regardless of the scope of non-compliance, the business must pay a plaintiff's attorney fees, the cost of the inspection and costs associated with filing the suit.

California law has historically further promoted drive-by lawsuits by making every ADA violation worth \$4,000 in damages to a complainant, in addition to the remedies available under the ADA. California has more drive-by lawsuits than any other state—more than 40% on nationally based industry reports.

In an effort to reduce the number of lawsuits, the California legislature passed Senate Bill ("SB") 1608, which became effective in 2013.

Certified Access Specialists

The intent of California's new law is (1) to promote increased ADA compliance through promotion of certified access specialist ("CASP") inspections and (2) to provide protection to businesses that undergo a CASP inspection. A CASP is a person who has been tested and certified by the state to assess accessibility. SB 1608 sets up a process whereby business owners can voluntarily hire a CASP to inspect their buildings to ensure compliance with disability access standards and obtain an inspection report as proof of inspection.

A related law (California Civil Code § 1938) requires that all commercial leases disclose whether the premises have been CASP-inspected and, if so, whether the CASP has determined that the property meets all applicable construction-related accessibility standards. CASP-inspected businesses have 60 days to fix an alleged violation. If a violation is remedied, the business's statutory damages may be reduced from \$4,000 to \$1,000 for each offense.

The law prohibits pre-litigation "demand for money" letters. Instead an "intent to sue letter" must be sent to a business owner who may be in violation, at least 30 days prior to filing a lawsuit. The letter must specify the access problems and date of the violation so that business owners will know why they are being sued.

SB 1186 limits the ability of a plaintiff to file multiple claims for a single violation—e.g., repeated visits to a business with a doorway that is too narrow, according to the law.

Proponents of the law had hoped that the protections for having CASP inspections would be more helpful. Probably, most importantly, business owners hoped for a period after notification of a violation within which to cure the violation without any fine or the threat of attorney fees. So far, most developers have chosen not to have such inspections. Moreover, most retail real estate leases executed after California Civil Code § 1938 became effective merely disclose that no CASP inspection of the premises has been undertaken.

It will be interesting to see not only if the situations change in California but also if other states take similar steps to address business concerns that drive-by lawsuits are unfairly prosecuted.

Conclusion

While this article is not meant to be a comprehensive list of trending sustainability and accessibility mandates affecting shopping center operations, the information provided is intended to give guidance on some important current regulation and incentives affecting the shopping center industry. Given the importance of environmental and accessibility issues in our society, we can be confident that each level of government will continue to assess these and other steps to promote best practices in our industry.

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Owners of Contaminated Shopping Centers May Benefit From California Tank Fund Law Amendments

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Recent changes to the California Tank Fund Law will make it easier for some owners of contaminated shopping centers to receive financial assistance to help clean up the property, and the law will now provide funding for cleanup of non-tank-related contamination. California Senate Bill (“SB”) 445 (Stats 2014, Ch. 547) was authored by Sen. Jerry Hill of Senate District 13 (Southern San Mateo and Northern Santa Clara County), and was passed on September 24, 2014. The amendments will affect—and perhaps benefit—business and property owners using Underground Storage Tanks (“USTs”). The amendments extend the expiration date of the Underground Storage Tank Cleanup Fund Program (“UST Fund”) to January 1, 2026, require closure of single-walled USTs by 2025 and create multiple mechanisms to provide financial assistance for cleanup of contamination, especially for sites in small and financially disadvantaged communities.

While USTs are typically thought of as features in industrial settings, many retail complexes now include gas stations, automotive repair shops or oil change facilities, all of which may have USTs. The storing of petroleum products, such as oil, gasoline, diesel, propane, and waste petroleum products or solvents, usually involves the use of one or more USTs. Warehouse or department stores often have discount automotive service centers on-premises, and gas stations and quick oil-change facilities make many shopping centers attractive—providing convenient, one-stop, full-service amenities. While these shopping centers provide valuable services that attract more customers, USTs always carry the risk of a release from a failed tank, with the resulting soil and/or groundwater contamination. Cleanup of petroleum releases to soil and groundwater is nearly always a lengthy, costly and disruptive process; may trigger litigation; and can mark a center with a stigma. California has strict regulations on USTs, a legal regime to ensure the speedy cleanup of leaking underground storage tank (“LUST”) sites, and incentives for businesses to permanently close USTs.

Basic State and Federal Laws Governing USTs

Storage of hazardous substances in USTs can carry significant risk of contamination to the environment, so there are stringent state and federal laws in place to ensure that tank owners and operators act responsibly. Pursuant to United States Environmental Protection Agency regulations on Technical Standards and Corrective Action Requirements for Owners and Operators of USTs,¹ owners and operators of USTs “must demonstrate financial responsibility for taking corrective action and for compensating third parties for bodily injury and property damage caused by accidental releases arising from the operation of petroleum underground storage tanks . . .” 40 C.F.R. § 280.93. These financial responsibility requirements exist so that if a tank were to fail and cause a release to the environment, the authorities can be confident that the owner or operator has the funds to pay for the cleanup. California’s former state senator, Barry Keene (D-Benicia, CA), *Underground Storage Tank Cleanup Trust Fund Act of 1989* (“the Tank Fund Act” or “the Act”) created the Tank Fund, which is administered by the California State Water Resources Control Board (“Water Board”). The Tank Fund provides a mechanism to assist owners and operators of USTs in meeting financial responsibility requirements.² The Act attaches a small fee onto every gallon of petroleum stored, and the resulting fund is used to reimburse small businesses for costs incurred to clean up leaking underground storage tanks.

Amendments to the Tank Fund Law

The recent Tank Fund amendment extends the Tank Fund Act for an additional 10 years—until January 1, 2026. Cal. Health & Safety Code § 25299.50.7. The amendment increases the fee assessed on petroleum storage from \$.014 per gallon to \$.02 per gallon. The law now requires all single-walled USTs to be permanently closed on or before December 31, 2025, which will affect all businesses using this older type of tank. Cal. Health & Safety Code § 25292.05. If the single-walled UST “poses a high threat to water quality or public health,” then the Water Board may adopt regulations to require the owner or operator to permanently close that UST earlier than December 31, 2025.

The Tank Fund amendment also creates an Expedited Cleanup Account (“ECA”) pilot project by transferring \$100 million from the UST cleanup fund to be used to pay claims brought under the Tank Fund Act. Cal. Health & Safety Code § 25299.50.7. Under the pilot project, the Water Board, with stakeholder input, will investigate methods to reduce the overall cost of site cleanup and the time to reach closure by increasing coordination with the responsible parties, consultants, regulators and the Fund, and by using multi-year budgets.

The Orphan Site Cleanup Fund, a grant program within California’s Division of Financial Assistance, provides assistance to sites affected by LUSTs where there is no financially responsible party and the applicant is not eligible to make a claim to the UST Cleanup Fund. The Orphan Site Cleanup Fund provides both site assessment and cleanup grants. This existing law was amended to increase eligibility for the Orphan Site Cleanup Fund by eliminating the requirement that funds only be available to sites qualifying as brownfields.³ Under the amendments, the maximum amount the Board is authorized to pay

for corrective action (cleanup) claims filed on or after January 1, 2015, decreases from \$1.5 million to \$1 million per occurrence, but increases the limit for technical regulatory assistance from \$3,000 to \$5,000.

Site Cleanup Subaccount Program

One of the most significant features of the recent amendments is the establishment of the Site Cleanup Subaccount Program ("SCAP"), funded by annual appropriations, with \$19.5 million anticipated in fiscal year 2015/2016.⁴ According to the Water Board, SCAP is "intended to clean up under-funded [Site Cleanup Program] sites [which] could include many 'mom and pop' dry cleaner spill sites."⁵ Notably, SCAP has no requirement that the contamination originate from a UST. Both large and small shopping centers in California containing dry-cleaning businesses, which often are the source of soil and groundwater contamination, may be eligible for funds from SCAP for cleanup.

SCAP will provide grants to "remediate harm or threat to human health, safety and the environment from surface or groundwater contamination," where the Water Board has issued a cleanup order and the responsible party lacks sufficient financial resources to pay for the required response action. Cal. Health & Safety Code § 25299.50.6(b)(3). The provision contains a list of factors that the Water Board must consider when determining whether to issue such a grant:

- The degree to which human health, safety and the environment are threatened by surface water or groundwater contamination at the location.
- Whether the location is located in a small or financially disadvantaged community.
- The cost and potential environmental benefit of the investigation or cleanup.
- Whether there are any other potential sources of funding for the investigation or cleanup.
- Any other information that the board identifies as necessary for consideration.⁶

The other requirement is that SCAP grants are available only for human-made contaminants. Human-made contaminants include most common pollutants such as PCE (dry-cleaning solvent), TCE and DCE (solvents), benzene, pesticides, and MTBE, among others, but would *not* include, for example, naturally occurring arsenic or heavy metals. The grants are available to any eligible person, although documentation is required to show that the responsible party lacks sufficient financial resources and that there are no other potential sources of funding for the investigation or cleanup. Pre-applications will be available to the first applicants in July 2015, with the final application available in August 2015.⁷ The Water Board will consider the applications in fall and winter of 2015, with the first grant agreements issued in 2016.

SCAP grants will benefit property owners who are issued a cleanup and abatement order by the Water Board and who have limited resources. In situations where no other potentially responsible party has been identified, as often occurs in cases of shopping centers with historical dry-cleaners, SCAP could provide the funding necessary to carry out the cleanup so that the property can be redeveloped or sold. However, those owners should make sure that no other sources of funding exist—such as historical commercial general liability policies issued to the property owner or dry-cleaner, lawsuits, or other public funding—before applying to SCAP. The program is being developed. At the time of this writing, the Water Board is still seeking feedback on draft Pre-Application forms and instructions. As such, specific standards as to what must be shown to prove lack of funding have not yet been established.

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¹ Title 40, Protection of Environment, Part 280, Code of Federal Regulations.

² The EPA has specifically approved California's Tank Fund Law as a mechanism for meeting the federal financial responsibility requirements for USTs containing petroleum.

³ The term "brownfield" means real property, the expansion, redevelopment or reuse of which may be complicated by the presence or potential presence of a hazardous substance, pollutant or contaminant.

⁴ SCAP Fact Sheet, available at http://www.waterboards.ca.gov/publications_forms/publications/factsheets/docs/scap_factsheet.pdf.

⁵ Memo to Bruce Wolfe, California Regional Water Quality Control Board San Francisco Bay Region, Executive Officer, from Stephen Hill, Chief Toxics Cleanup Division, Subject: Case Prioritization and Management in the Cleanup Programs—Status Report, March 27, 2015, at 6. Available at: http://www.waterboards.ca.gov/sanfranciscobay/board_info/agendas/2015/April/5_ssr.pdf.

⁶ *Id.*

⁷ Application information will be available at: http://www.waterboards.ca.gov/water_issues/programs/grants_loans/scap/.

Indemnity and Non-Payment Claims on Construction Projects: You May Have Longer Than You Think

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Construction lawyers in Illinois and many of their clients have come to understand generally that claims arising out of the design or construction of an improvement to real property must be asserted within four years of the date of discovery of the claim. This understanding is based on the construction statute of limitations and repose contained in 735 ILCS 5/13-214. That understanding is often well-founded, but Illinois courts have, over the years, issued decisions demonstrating that simply because a claim has some connection to design or construction does not necessarily mean that the four-year statute of limitations applies. The precise language of § 13-214 and the judicial interpretation of that language shows that in many cases a claim arising from a construction project, depending upon the nature of the claim, may be subject to a much longer statute of limitations. For lawyers and their construction clients, it is important to understand the implications of these decisions.

The Latest Decision—A Contractor's Indemnity Obligation

In 2014, the Illinois Appellate Court held that a developer's express indemnity claim against a third-party defendant contractor was governed by the ten-year statute of limitations generally applicable to written contracts and not by the four-year statute of limitations for construction-related claims—even though the underlying lawsuit against the developer included claims for workmanship defects. In *15th Place Condominium Association v. South Campus Development Team*,¹ South Campus Development Team ("SCDT") was the developer of two adjacent condominium towers located at 811 and 833 West 15th Place in Chicago, Illinois (the "Project"). SCDT contracted with Fitzgerald Associates Architects P.C. ("Fitzgerald") for architectural services and with Linn-Mathes, Inc. ("Linn-Mathes") to be the general contractor for the Project. In April 2005, after a number of condominium units were sold, SCDT turned over control of the Project to 15th Place Condominium Association (the "Association").

In 2008, following turnover, the Association discovered many design and workmanship defects and filed a lawsuit against SCDT, which included claims of breach of the implied warranty of fitness and habitability, breach of fiduciary duty, and negligence. In June 2011, SCDT filed a third-party complaint against Fitzgerald and Linn-Mathes, alleging claims for breach of contract, breach of implied warranty of good workmanship, express indemnity, and, alternatively, implied indemnity against both Fitzgerald and Linn-Mathes. Among other things, the trial court dismissed the express indemnity claim against Linn-Mathes as being barred by the four-year statute of limitations set forth at 735 ILCS 5/13-214.

The appellate court reversed, basing its decision upon the Illinois Supreme Court's ruling in *Travelers Casualty & Surety Co. v. Bowman*,² which held that a written agreement to indemnify was not one of the activities protected under the four-year statute of limitations applicable to construction matters (i.e., the design, planning, supervision, observation or management of construction), but was instead subject to the ten-year statute of limitations applicable to written contracts. As in *Travelers*, the express indemnity claim against Linn-Mathes arose from Linn-Mathes' refusal to perform its obligation to indemnify SCDT pursuant to an express promise to indemnify SCDT contained in the contract between the parties. Consequently, Linn-Mathes' action or inaction as an indemnitor was not protected under 735 ILCS 5/13-214(a), and therefore the ten-year statute of limitations applicable to written contracts under 735 ILCS 5/13-206 applied to SCDT's express indemnity claim against Linn-Mathes.

What is striking about the *15th Place* decision is that the indemnity claim was so closely tied to an underlying act, error or omission in connection with the construction of the condominiums. The genesis of the indemnity claim was in fact the construction of an improvement to real property. Notwithstanding the factual underpinnings of the indemnity claim, the Illinois appellate court focused on the precise duty alleged to be breached—the duty to indemnify. That duty is not one of the enumerated activities in 735 ILCS 5/13-214(a), so the four-year statute of limitations did not apply.

A Principal's Indemnity Obligation to Its Surety

The linchpin for the court's decision in *15th Place* was the *Travelers* decision that also involved a duty to indemnify, but under different circumstances. In *Travelers*, a surety issued three performance bonds to a metalworking contractor for projects on two correctional facilities and a college campus. These bonds secured the metalworking contractor's performance of its contractual obligations. Before these bonds were issued, the surety obtained a written general indemnity agreement signed by the contractor's president and sole shareholder. The surety eventually had to pay more than \$500,000 in losses, costs and expenses under the bonds in 1994 and 1996.

The surety filed a complaint against the contractor's president and sole shareholder in October 2004, seeking reimbursement for the amounts paid pursuant to the general indemnity agreement that backstopped the bonds.³ The president and sole shareholder moved to dismiss the complaint as time-barred under 735 ILCS 5/13-214(a) because the complaint was filed more than four years after the claim was discovered. The trial court granted the motion to dismiss.⁴ On appeal, the Illinois Appellate Court reversed and held that the complaint was timely because the applicable statute of limitations was the ten-year statute for actions based on written agreements set forth in 735 ILCS 5/13-206.⁵

The Illinois Supreme Court agreed with the appellate court. The supreme court began its analysis with a review of applicable principles in determining which statute of limitations applies to a cause of action. The court stated:

[t]he determination of the applicable statute of limitations is governed by the type of injury at issue, irrespective of the pleader's designation of the nature of the action. [citations omitted] In identifying the applicable limitations period . . . "[w]e have long held that 'it is the nature of the plaintiff's injury rather than the nature of the facts from which the claim arises which should determine what limitations period should apply.'" [citations omitted] To determine the true character of a plaintiff's cause of action, [we] emphasized that "[t]he focus of the inquiry is on the nature of the liability and not on the nature of the relief sought." [citation omitted]⁶

Applying these principles, the Illinois Supreme Court concluded that the surety sought damages from the contractor's president and sole shareholder based on their failure to perform the contractual duties set forth in the written indemnity agreement. Those duties were:

[t]o indemnify, and keep indemnified, and hold and save harmless the Surety against all demands, claims, loss, costs, damages, expenses, and attorney fees whatever, and any and all liability therefore, sustained or incurred by the Surety by reason of executing or procuring the execution of any said Bond or Bonds, or any other Bonds, which may be already or hereafter executed on behalf of the Contractor, or renewal or continuation thereof, or sustained or incurred by reason of making any investigation on account thereof, prosecuting or defending any action brought in connection therewith, obtaining a release therefrom, recovering or attempting to recover any salvage in connection therewith or enforcing by litigation or otherwise any of the agreements herein contained. Payments of amounts due Surety hereunder together with legal interest shall be payable on demand.⁷

The surety alleged that the president and sole shareholder, after a written demand was made, failed to indemnify the surety. The Illinois Supreme Court stated that the defendants failed to pay under the indemnity agreement and that was the basis of the claim—not a failure to perform construction work, even though that latter failure was what triggered the surety's duties under the performance bond.⁸ The court explained its rationale:

[The contractor's] breach of construction contracts resulted in payment of claims under the performance bonds. The payment of claims under the performance bonds then triggered the [president's and sole shareholder's] obligation to perform under the indemnity agreement. The [president's and sole shareholder's] liability to [the surety] does not, however, emanate from [the contractor's] breach of the construction contracts. Rather, the [president's and sole shareholder's] liability emanates from the refusal to perform their obligation of indemnification under the written indemnification agreement after claims were made against the underlying performance bonds. We hold, therefore, that section 13-214 is inapplicable to [the surety's] cause of action.⁹

The applicable statute of limitations was instead the 10-year statute in 735 ILCS 5/13-206.

This passage from the *Travelers'* decision captures the logical progression that the court in *15th Place* followed. Even if the factual origins of a claim emanate from a construction project, the courts will focus on the alleged injury and the alleged breach of duty. Unless the claim involves one of the specifically enumerated activities in 735 ILCS 5/13-214(a)—i.e., an act or omission in the design, planning, supervision, observation or management of construction, or construction of an improvement to real property—then another statute of limitations will apply.

An Owner's Failure to Pay for Construction Work

The Illinois courts have also applied the ten-year statute of limitations in the context of a contractor's claim for non-payment against an owner. While most prudent contractors will act swiftly to preserve and advance mechanics lien rights, in some cases, contractors may only be able to assert contract claims unsecured by a mechanics lien. In many such cases, contractors have up to 10 years in which to file a claim.

One of the leading cases illustrating this point is *Prate Installations, Inc. v. Thomas*.¹⁰ In *Prate*, the contractor was hired to perform roofing repairs on a residence. The work was completed in October 2000. The contractor repeatedly invoiced for the work, but the homeowners never paid. The contractor filed suit in March 2005. The homeowners moved to dismiss based on the four-year statute of limitations in 735 ILCS 5/13-214(a). The trial court agreed with the defendants and dismissed the contractor's claim.

The Illinois Appellate Court reversed because the defendants were not protected by the statute of limitations contained in 735 ILCS 5/13-214(a). The court stated:

[a]s defendants recognize, plaintiff, rather than defendants, arguably engaged in an activity protected by the statute. Defendants are being sued for their alleged failure to pay a bill rather than for their act or omission in the construction of an improvement to property. Thus, defendants are not protected by section 13-214(a).¹¹

Because failure to pay a bill for construction services is not one of the enumerated activities in 735 ILCS 5/13-214(a), that section did not apply. Instead the ten-year statute of limitations set forth in 735 ILCS 5/13-206 applied, and the contractor's claim was timely.

Conclusion

A variety of claims can arise from a construction project. The statute of limitations that will apply to such claims will depend upon the nature of the activity involved and the type of injury. The *Travelers, 15th Place* and *Prate* cases strongly support the proposition that an obligation to make a payment—whether pursuant to a written indemnity or a written contract—is not an activity that will enable a defendant to invoke the four-year construction statute of limitations. On the other hand, aggrieved parties who believe that a payment is due for a written financial obligation that arises from a construction project appear to have a much longer time frame to assert claims.

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¹ *LLC*, 2014 IL App (1st) 122292.

² 229 Ill.2d 461 (2008).

³ *Travelers* at 464.

⁴ *Id.* at 465.

⁵ *Id.*

⁶ *Id.* at 466–67.

⁷ *Id.* at 468.

⁸ *Id.*

⁹ *Id.* at 470.

¹⁰ 363 Ill. App. 3d 216 (2d Dist. 2006).

¹¹ *Id.* at 219.

Should You Consider Representations & Warranties Insurance in Your Real Estate Deal?

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Introduction

Representations and warranties insurance (“R&W insurance”) has been available for over 15 years, but only recently has it become commonplace in mergers and acquisitions (“M&A”) transactions. Now that it has been established in the M&A sector, parties to real estate transactions are beginning to realize that R&W insurance can play an important role in these deals as well.¹ Particularly as real estate deals have become more complicated, with real estate being traded as an asset owned by entities such as real estate investment trusts, R&W insurance can help facilitate these transactions. Indeed, what makes R&W insurance so attractive in M&A deals applies equally to real estate deals, and parties to complex real estate transactions may wish to consider obtaining an R&W insurance policy.

What Is R&W Insurance?

R&W insurance protects buyers and sellers from financial loss resulting from inaccuracies in the representations and warranties that were made as part of the transaction. In a transaction, parties often make representations and warranties about certain material facts in order to induce the other party to enter the transaction. For example, in complex real estate transactions where ownership in real estate is being transferred as an asset, typical representations and warranties may include information about the assets and the seller, including their financial status, and any liabilities that are being transferred in the transaction.² In more standard real estate deals, typical representations and warranties include:

- The status and authority of the seller, such as its financial state and its ability to enter into the contract;
- The current status of the property, such as compliance with applicable codes and ordinances and lack of any unrecorded liens against the property; and
- The proper operation of the property, such as all leases being in effect with no current breaches and the accuracy of all rent rolls and records.³

R&W insurance is designed to provide insurance coverage for the breach of particular representations and warranties that are made as part of a transaction, protecting the other party in the event that a representation or warranty is untrue and the party is damaged by the inaccuracy of that statement. Because representations and warranties tend to be discoverable facts, R&W insurance essentially protects the parties against any deficiencies in conducting due diligence in the transaction.⁴

R&W insurance can be either buyer-side or seller-side. Although, typically, buyers want R&W insurance because they are more likely to be harmed by a breach in a representation or warranty, in certain situations R&W insurance may be desirable for sellers as well. Seller-side insurance is third-party liability coverage, in that a seller purchases the insurance to cover against any losses to the buyer.⁵ Rather than having to maintain assets in escrow to insure an indemnification provision, a seller-side R&W policy can allow a seller to liquidate or end its operations after the closing. This might be the case when investors in a real estate investment trust wish to sell any remaining assets and fully distribute all of the proceeds from the transaction.

When Might You Need R&W Insurance?

Because R&W insurance shifts the risk of unknown breaches of representations and warranties in a transaction to an insurance company, it reduces the stakes on both the buyer and seller in negotiating the contract. However, R&W insurance generally makes sense in larger, more complex real estate transactions that involve transferring interests in entities, such as acquiring real estate through entity acquisition, asset purchase and corporate merger. In these transactions, R&W insurance would serve the same purpose and provide the same coverage as other types of M&A transactions.

Where an entire portfolio of real estate is being sold or ownership of a real estate holding entity is changing in a complex way, R&W insurance is useful, as the parties cannot easily monitor and verify the representations and warranties relating to so many properties, and there are more opportunities for something to go wrong. Similar to R&W insurance for M&A deals, the insurance in such a real estate transaction would cover entity-level representations, tax representations, representations related to the accuracy of financial statements and representations regarding any liens on the shares being traded.

R&W insurance generally would not be necessary in a simple purchase and sale of a single piece of real estate. Representations and warranties about real property can usually be discovered fairly easily through a title search on the property, and many concerns about the real property can be addressed through title insurance. Further, in most real estate transactions, the property is sold as-is, without representations or warranties as to the physical or environmental condition of the

property, the property's financial performance or other characteristics that could be important to the buyer. Instead, the buyer will have an opportunity to conduct due diligence and determine whether or not to proceed with the transaction.

However, in certain situations where due diligence could not provide the buyer with important information, R&W insurance could be desirable. For example, a real estate transaction could involve property with uncertain tax treatment, such as a transaction involving § 1033 of the Tax Code, dealing with the replacement of property taken by condemnation, or § 1031 of the Tax Code, dealing with like-kind simultaneous or deferred exchanges.⁶ The tax treatment of such property may not be easily assured based on the existing law, and the buyer may wish to obtain representations and warranties from the seller in case the expected tax treatment is challenged.⁷

R&W insurance could also be useful when the property that is the subject of a transaction is an historic building and the deal involves investments in historic tax credits. To complete the investment successfully, investors may need to be induced into investing in the project through representations and warranties about the project and the historic tax credit implications.

Further, real estate transactions that involve the transfer of permits that allow the property to operate may benefit from R&W insurance covering a seller's representations and warranties regarding the validity of those permits.

Moreover, R&W insurance can cover representations and warranties about particular environmental matters that environmental insurance or title insurance will not cover, or that would be very expensive to cover under those policies.

Why Might You Need R&W Insurance?

Most transactions include representations and warranties that are secured by indemnification provisions, an escrow account, letter of credit or some other form of security.⁸ R&W insurance is desirable because it can reduce or eliminate the need for these workaround measures, which can hold up the negotiation of a transaction. Buyers and sellers often cannot agree upon whether a specific representation or warranty will be included in the transaction, what the precise scope of an indemnity provision should be and what size escrow account is necessary. R&W insurance can facilitate the transaction by supplementing or replacing an indemnity and ensuring that a breach of a representation or warranty will be protected, without the need for contractual workarounds.

As a result, R&W insurance can lower the cost of the transaction and let both parties maintain a more congenial relationship in the negotiation process. This can be of particular value where the sellers will remain affiliated with the property after the transaction—for instance, where a seller has been managing the property and will to continue to manage it after the sale. In shopping centers that are struggling financially, R&W insurance can entice potential buyers who might otherwise shy away from the transaction because of their concern about the strength of the seller's covenants or because they fear they may not be able to recover from the seller post-completion of the transaction if the seller is liquidated.

Conversely, if a financially distressed seller wants to liquidate after the sale, R&W insurance can facilitate this process by removing the need for it to hold funds in escrow. By providing the security that the escrowed funds typically serve, R&W insurance lowers or eliminates the need for funds to be escrowed, and allows a seller to liquidate sale proceeds quickly.

Other Considerations

The terms of R&W insurance are flexible and tend to be tailored to the specific representations and warranties included in the transaction. However, R&W insurance generally will not cover any known liabilities at the time of the policy; it will only cover unintentional and unknown breaches.⁹ If a buyer discovers a potential issue during due diligence, it is not entitled to coverage under R&W insurance. And, if a seller intentionally makes a false representation, a buyer may have other claims against it, but breach of that representation typically will not be covered by R&W insurance.

Although this is a relatively new insurance market, gains in the popularity and use of R&W insurance should result in price reductions. The insurance is not cheap and may not currently be suitable for all real estate transactions. The cost of the coverage and the amount of coverage that the insurance company will provide should be balanced against both the value of - and the risk associated with - the transaction. Still, for shopping centers under complex ownership structures or which are included in the shares of an entity's portfolio, R&W insurance could be an important tool in facilitating transactions.

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¹ See Andrew McIntyre, *Reps & Warranties Insurance Creeping into Real Estate Deals*, Law 360 (May 4, 2015), available at http://www.law360.com/realestate/articles/650115?nl_pk=d5a5ca65-5b60-49e1-ba81-9d93be91d2ef&utm_source=newsletter&utm_medium=email&utm_campaign=realestate.

² See 4 Appleman on Insurance § 32.02.

³ See Lee A. Chilcote, *Representations and Warranties Insurance: A New Insurance Product for Real Estate Transactions?*—presentation at the American College of Real Estate Lawyers, Boston, MA (Oct. 12, 2000).

⁴ See 4 Appleman on Insurance § 32.02.

⁵ *Id.*

⁶ See Lee A. Chilcote, *Representations and Warranties Insurance: A New Insurance Product for Real Estate Transactions?*—presentation at the American College of Real Estate Lawyers, Boston, MA (Oct. 12, 2000).

⁷ *Id.*

⁸ Michael A. Rossi, *Insuring Representations and Warranties in Mergers and Acquisitions*, 22 RISK REPORT No. 8 (Apr. 2000).

⁹ See 4 Appleman on Insurance § 32.02; — see also *Ins. Co. of North America v. Kayser-Roth Corp.*, 770 A.2d 403, 415 (R.I. 2001); *General Housewares Corp. v. National Surety Corp.*, 741 N.E.2d 408 (Ind. 2000); *Meridian Mut. Ins. Co. v. Majestic Block & Supply, Inc.*, 1 N.E.3d 173 (Ind. Ct. App. 2013).

What Is The Net Impact Of 'Net' Language?

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Although the use of such words as “net lease,” “net net,” “triple net lease,” “net and carefree,” “fully net” or “absolutely net” are often used to describe types of leases, it is not always clear what the parties mean when such terms are used. As several commentators have noted, the degree of “netness” of a lease varies greatly from lease to lease causing a great deal of ambiguity.¹

One traditional view has been that each “net” in a lease represents a specific category of expenses. Therefore, “single net” represents the payment of real estate taxes by the tenant (along with the base rent²), “double net” represents the payment of real estate taxes and insurance by tenant and “triple net” represents real estate taxes, insurance and maintenance costs.³ Unfortunately, the terminology is not universally agreed upon by all parties.

Based upon the discussion above one might expect that a “net” lease would require only that the tenant pay real estate taxes. However, a landlord may use the words “net lease” as shorthand to describe a lease equivalent to a “triple net” lease despite the presence of only one “net” in the description. This is reflected in Black’s Law Dictionary (9th ed., 2009) [10th ed. 2015] which defines a “net lease” as a lease in which the tenant pays “rent plus property expenses (such as taxes and insurance).” One commentator likened the “net lease” to a mortgage payment, with the tenant, like a property owner with a mortgage, being responsible for all costs relating to the property.⁴ The result is that a “net lease” may refer to any of the types of leases described above.

Similarly, the definition of a triple net lease also remains subject to interpretation, particularly with regard to the third “net.” The “maintenance” costs may range from a contribution by the tenant towards maintenance of any common areas, to contribution for repairs and replacements of common area or all the way to contribution toward every cost incurred by the landlord in connection with the “ownership, operation and maintenance” of the shopping center.

The expansive definition of the third leg of the triple net lease is supported by Black’s Law Dictionary which defines a “net-net-net lease” (a “triple net” lease) as one in which the tenant “pays all the expenses, including mortgage interest and amortization, leaving the lessor with an amount free of all claims.” This might surprise many tenants who would expect the basic definition to exclude the costs of the landlord’s financing from the “additional rent” payable under the lease.

The landlord’s perspective is that “base rent” is the rent intended to “philosophically represent the return to the landlord for the use of the space and the value of the improvements” separate from the costs of ownership, operation and maintenance of the property.⁵ The “base rent” is simply compensation for the landlord’s investment and risk in the real estate, and no more.⁶ Of course, the landlord will also argue that since the tenant is covering these costs (which would otherwise be borne by the landlord), the base rent charged in a triple net lease is generally lower than the rent charged for a “gross lease.”⁷

Case

A recent case in the state of Washington, *Viking Bank v. Firgrove Commons*⁸, illustrates the ambiguity that can arise without further definition of such a term. In this case, the Court of Appeals of Washington ruled that “net lease” language did not allow the landlord to charge the tenant (a standalone bank in a shopping center) for certain property management fees. The relevant provision of the lease provided as follows:

All Base Annual Rent payable hereunder shall be paid as “triple net” rent without deduction or offset. It is the intent of the parties, except as is otherwise provided in this Lease, that Base Annual Rent provided to Landlord shall be absolutely net to Landlord, and Tenant shall pay all costs, charges, insurance premiums, taxes, utilities, expenses, and prorated share of maintenance for common area CAM expenses, and assessments of every kind and nature incurred for, against, or in connection with the Ground Leased Premises and Property.

The landlord hired a property manager to manage the shopping center without any consultation with the tenant. In addition to maintaining the shopping center’s common areas (e.g. common entrances and exits, drives and sidewalks), the property manager performed administrative functions relating to the tenant’s lease, such as billing it for monthly rent, property taxes, and sewer charges.

The landlord argued that the “common understanding of a triple net lease is a broad shifting of expenses from the landlord to the tenant,” that the parties “intended to allocate to the tenant all the expenses in connection with the leased property, leaving the landlord with no expenses” and that the “plain language” of the lease (“all costs, charges . . . of every kind and nature”) supported this interpretation. More specifically, the landlord argued that, if the tenant did not pay the property management fee, the rent under the lease would not be “net” to the landlord.

The tenant refused to pay such amounts, believing that the lease did not contemplate the inclusion of such costs since the tenant self-maintained its own premises (apart from the common areas) and that the landlord was hiring a third party to perform administrative tasks that the landlord could perform itself.

The landlord believed that the word “absolutely net” together with the other language of the provision provided the landlord with sufficient basis to seek reimbursement (on a pro rata basis) from the tenant for the cost of retaining the property manager. Unfortunately for the landlord, the court rejected the landlord’s position for several reasons.

Decision

The court rejected much of the landlord’s reasoning on three grounds.

- First, the court made a distinction between the property management company’s responsibilities that related to administration of the “lease” (e.g., collecting rent, paying property taxes) and those responsibilities that related to the “leased property” and held that the former were not covered by the “net” language of the lease.
- Second, the court determined that since more general terms (e.g., costs, charges and expenses) were followed by a specific list of items (e.g., insurance premiums, taxes, utilities, etc.), that were limited by the words “in connection with the Ground Leased Premises and Property,” the legal maxim “*ejusdem generis*” was applicable. As a result, the court determined that only those costs that were for the benefit of the tenant’s use and occupancy of the Premises, were covered by the “net” language. In contrast, the landlord’s hiring of a property management company to collect the rent and perform other similar functions was for the landlord’s own “benefit and convenience.” Finally, the court relied on the fact that the tenant was required to act as a property manager for its own premises so that requiring the tenant to pay a property management company would be duplicative of some of the tenant’s own activities.

Interestingly, the court reached its decision in spite of specifically citing the Black’s definition of a triple net lease which (as discussed above) provides a very attractive definition of a “triple net lease” from the landlord’s perspective. Similarly, the court also made its decision despite citing the *Washington Real Property Deskbook Series: Real Estate Essentials*, which defined an “absolute net” lease as one that “implies that the landlord is to have no expense associated with the property.”

Fundamentally, it seems the court was reluctant to require that the tenant pay for services that the court viewed as a core responsibility of a landlord.¹⁰ The court’s position is best summed up by its statement that the tenant need not reimburse the landlord for a “management fee landlord unilaterally incurred for its own benefit and convenience.”

However, the decision was by no means a complete victory for the tenant. The court ruled that, to the extent that the property management company’s services were “necessary for common area maintenance,” the tenant was required to pay those expenses relating to providing those services. The court implied that if the landlord could allocate the property manager’s fees to those items specifically related to common area maintenance (e.g., overseeing sidewalk repair) then the tenant would have to pay such expenses.

Lessons Learned

It should be clear from the discussion above that the use of the words “net lease,” “triple net lease,” “absolutely net lease” “fully net” or “net and carefree” do not suffice to determine exactly which costs may be passed through to the tenant. Instead, the parties must take additional steps to clarify their respective obligations under the lease.

The landlord and tenant should specifically address the following issues:

1. The landlord and tenant should specifically clarify whether the “net” concept of the lease cover all costs, expenses and charges relating to the lease, the premises and the balance of the shopping center. This will avoid any argument similar to that made in *Viking Bank* case that costs relating to the lease (as opposed to the premises and shopping center) are excluded.
2. The landlord and tenant should include a list of those specific items to be included and excluded from the costs to be reimbursed by the tenant. Furthermore, to avoid any confusion regarding the nature of the list, it should be clear if the list limits reimbursement to those specific items or if the list provides examples of those items for which the tenant is responsible. If the list is non-exhaustive, this can be handled by having the list prefaced with a statement that such items are noted “By way of example only” or using language such as “Without limiting the generality of the foregoing” after the concept.
3. If the lease is intended to cover cost items typically seen as relating to the landlord’s core role as the owner of the shopping center, then the lease should specifically reference such items. For example, the lease should specifically include or exclude items such as (i) property management fees, including costs of collecting rent, preparing budgets, accounting and bill paying activities; (ii) environmental conditions preceding the term of the lease; (iii) capital expenditures; (iv) structural repairs and replacement; (v) marketing expenses; and (vi) financing costs.
4. The tenant may be willing to contribute to certain costs subject to certain limitations, such as (i) a provision limiting third-party management fees to be limited to a percentage of the common area maintenance budget for the shopping center; (ii) amortization of any capital expenditures; and (iii) other measures (e.g., bidding) to assure that any such costs are competitively sourced in the marketplace.

5. The parties should attempt to coordinate any other applicable provisions of the lease relating to maintenance, repair and replacement of the premises. For example, specific language in a lease detailing the surrender of the premises will inform the interpretation of other provisions of the lease including “net” language dealing with repair and maintenance.¹¹
6. Some landlords have drafted additional language requiring the tenant to “defend, save harmless and indemnify landlord so as render the base rent absolutely net.” Without delving into how the concept of indemnity relates to damage claims between contracting parties (e.g., foreseeability, duty to mitigate, etc.), such language may not expand or contract the “net-ness” of the lease. Consequently, all of the issues raised above must still be addressed regardless of the presence of such indemnity language.

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¹ Real Estate Leasing Practice Manual Database updated April 2007 Alvin L. Arnold and Jeanne O’Neill Part II. Complete Leases Chapter 55. Net Leases § 55:1. Definition. “Canadian Real Property: Theory and Commercial Practice” by S. Michael Brooks, Ph.D. (November 1, 2006).

² Also sometimes called “minimum rent” or “net rent”.

³ “Probing the Black Art of Common Area Maintenance: *CAM Disputes and CAM Caps: Considerations and Concerns*,” presented to the International Council of Shopping Centers 2012 U.S. Shopping Center Law Conference, Marriott Grand Lakes Orlando, Florida October 24–27, 2012, by Joel R. Hall, Esq. and Rory Packer, Esq.

⁴ “Net, Gross, and Full Service Leases –Comparing Apples with Oranges” by David G. Hunt, New York Real Estate Journal, July 15, 2003.

⁵ “Canadian Real Property: Theory and Commercial Practice” by S. Michael Brooks, Ph.D. (November 1, 2006).

⁶ “Net, Gross, and Full Service Leases –Comparing Apples with Oranges” by David G. Hunt, New York Real Estate Journal, July 15, 2003.

⁷ “Lease Distinctions: Ground Leases/Net Leases/Gross Leases Renovations/Build-to-Suits/Reverse Build-to-Suits,” presented to the International Council of Shopping Centers 2011 U.S. Shopping Center Law Conference, Arizona Biltmore Resort, Phoenix, AZ, October 26–28, 2011, by Tara Scanlon, Esq. and Lisa Schwartz, Esq.

⁸ Viking Bank v. Firgrove Commons, No. 44925-1-II, September 16, 2014.

⁹ The principle is that where a general term used in conjunction with specific terms will be deemed to include only those things that are in the same class or nature as the specific ones. Therefore, the general reference to “costs, charges and expenses” were limited by the words “Ground Leased Premises and Property.”

¹⁰ A similar decision was reached in a case in Ontario, Canada. See *C.C Tatham & Associates Ltd. v. 2057870 Ontario Inc.* (Ontario Superior Court of Justice, 2011).

¹¹ *Dorian v. S.S. Restaurant Corporation*, 2011 WL 1856014 (Ariz. App. Div. 1 2011).

Cases

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CO-TENANCY PROVISION

The Court of Appeals of Washington has examined the language of a co-tenancy provision of a retail lease, and has agreed with the tenant's position that the termination right granted to the landlord in that provision was more limited than the termination right granted to the tenant. *Michaels Stores, Inc., a Delaware corporation, v. RPAI Lakewood, L.L.C.*, No. 46071-8-II (Wash. App., March 10, 2015).

This is another case that highlights the importance of careful drafting, to assure that the language of a lease truly accomplishes the parties' intent.

The parties in this case were RPAI Lakewood, L.L.C. ("RPAI"), the owner of a shopping center, and Michaels Stores, Inc. ("Michaels"), a tenant in that center. RPAI and Michaels were parties to a lease that included a co-tenancy provision. That provision contemplated that the landlord must lease at least 70 percent of the total square footage of the shopping center to "Anchor Tenants," as defined in the lease. The provision allowed the tenant to pay alternative rent if the co-tenancy requirement was not satisfied for any six-month period. If the co-tenancy failure was not thereafter cured within a specified period, the landlord and tenant were each granted rights to terminate the lease.

A failure of the co-tenancy requirement occurred in May 2009. Six months later, Michaels began paying alternative rent. The co-tenancy failure continued in May 2010, but neither party exercised its termination right. Michaels exercised an extension right and continued to pay alternative rent. In December 2012, RPAI notified Michaels that it was exercising its termination right under the co-tenancy provision. Michaels resumed paying full minimum rent, under protest.

Michaels filed a declaratory judgment action seeking a determination that RPAI failed to timely exercise its termination right. Michaels also sought damages for the difference between the minimum rent paid under protest and the alternative rent. RPAI contended that the lease allowed RPAI to give a notice of termination at any time after the end of the 14th month following the initial co-tenancy failure. The parties agreed with Michaels that the end of the 14th month was July 31, 2010. The lower court granted summary judgment in favor of Michaels, and RPAI appealed.

The co-tenancy provision of the lease provided as follows, with respect to Michaels right of termination:

In addition to the rights of Tenant to pay "Alternative Rent", if . . . non-satisfaction of the On-Going Co-Tenancy Requirement shall continue for a period of twelve (12) months beyond the initial failure to meet the On-Going Co-Tenancy Requirement and for so long as such non-satisfaction shall continue, . . . Tenant shall have the right to terminate this Lease by sixty (60) days' written notice delivered to Landlord.

RPAI's termination right in the lease was stated as follows:

Landlord shall likewise have a right to terminate this Lease, at the end of the fourteenth (14th) month following the initial nonsatisfaction of the Co-Tenancy Requirement by giving sixty (60) days prior written notice to Tenant of the termination.

The parties agreed that the critical factor in the case was interpretation of the termination provisions, particularly the meaning of the word "likewise" in the description of the landlord's termination rights.

RPAI contended that "likewise" was intended to convey the same termination rights to the landlord as granted to the tenant, and that RPAI therefore had an ongoing termination right beginning on the last day of the 14th month of the co-tenancy failure. Michaels took the position that "likewise" only meant that RPAI was also granted termination rights and that §16.3 of the lease clearly stated the intent to limit RPAI's right of termination to its exercise at the end of the 14th month. Michaels further contended that RPAI's position would, in effect, rewrite the lease by construing "at" to mean "after," adding "for so long as" to RPAI's termination right so that both parties would have the right to terminate the lease as long as the co-tenancy failure continued, and interpreting "likewise" as granting RPAI the same termination rights as Michaels despite the different language used in the two provisions.

The appellate court reviewed the lower court's reasoning, including its determination that the plain language of the lease "unambiguously granted the landlord a one-time option to terminate the lease, that the landlord did not timely exercise that right, and that judgment on the termination issue should enter for Michaels as a matter of law."

RPAI argued that the lower court's decision ignored applicable facts and that there was no indication the parties intended such a major disparity in termination rights, with the tenant having an ongoing termination right while the landlord's termination right would last only one day. Michaels argued that it is commercially reasonable to give the tenant greater termination rights because the co-tenancy requirement was a major part of the bargain, and if RPAI had a continuing termination right, it would have much less incentive to cure the co-tenancy failure.

The court of appeals agreed with Michaels, saying that—because “the language of the contract is unambiguous and clearly shows that RPAI did not exercise its termination rights in a timely manner”—affirmed the lower court’s grant of summary judgment in favor of Michaels.

LANDLORD’S RIGHT OF ENTRY

The Iowa Supreme Court has interpreted the language of a lease relating to the landlord’s right of entry, finding in favor of the landlord’s position that the right to sell and finance the property includes the right to show the property to interested purchasers and lenders. *Alta Vista Properties, LLC v. Mauer Vision Center, PC*, No. 13-0496 (Iowa, October 31, 2014)

The parties in this case were Alta Vista Properties, LLC (“Landlord”), the owner of the property, and Mauer Vision Center, PC (“Tenant”). In 2003, the Tenant and Landlord’s predecessor-in-interest entered into a lease with a term of 15-1/2 years. The Landlord acquired the property from the original landlord in 2006; there was apparently no issue regarding showings of the property to prospective purchasers, including the Landlord, during that time. In 2012, the Landlord became interested in selling the property and contacted the Tenant, who refused to allow the Landlord access to the property to show it to prospective purchasers. The Landlord filed an action, seeking a declaratory judgment to have reasonable access to the property to show it to prospective purchasers.

The Tenant relied on Paragraph 12 of the lease, which was generally the provision dealing with the Tenant’s sign rights, but also stated that “Landlord, during the last ninety (90) days of this Lease, or any extension, shall have the right to maintain in the windows or on the building or on the premises a ‘For Rent’ or ‘For Sale’ sign, and Tenant will permit, at such time, prospective tenants or buyers to enter and examine the premises.”

The Tenant contended that this provision unambiguously limited the Landlord’s access, for the purpose of showing it to potential purchasers, to the last 90 days of the lease term. The Landlord argued that the lease, taken as a whole, gave the Landlord a reasonable right to show the premises to prospective purchasers throughout the lease term. The trial court granted summary judgment for the Tenant, and the Landlord appealed. The court of appeals affirmed that ruling, and the Landlord applied to the Iowa Supreme Court for further review.

On appeal, the Tenant again argued that because Paragraph 12 specifically required the Tenant to provide access for prospective tenants or purchasers during the last 90 days of the term, it therefore prohibited such access at other times. The Landlord, on the other hand, argued that the provisions of the lease granted the Tenant only with “non-exclusive use” of the premises, and that the lease expressly provided the Landlord with rights to sell and mortgage the property, and to assign the Landlord’s interest at any time—therefore, necessarily including the right to show the property to prospective purchasers and lenders.

The Iowa Supreme Court disagreed with the conclusions of the trial court and the court of appeals, stating that while Paragraph 12 of the lease required the Tenant to allow access for prospective tenants and purchasers during the last 90 days of the term, it did not say that that was the *only* time that such access was allowed. The court noted that Paragraph 12 was primarily a provision dealing with sign rights, not access. The court also looked to other provisions in the lease, including those stating that the Tenant’s use of the premises during the term was “non-exclusive” and those giving the Landlord the express right to sell and mortgage the property during the term of the lease. The court commented: “Who would buy or finance something he or she could not look at?” Further, the Iowa Supreme Court stated that the Tenant’s interpretation of the lease would lead to an unfair outcome, as the inconvenience to the Tenant of allowing access for the Landlord and prospective purchasers is minimal, but that the potential loss to the Landlord from not being able to show the property to prospective purchasers or lenders is substantial, as the Landlord “would likely be unable to sell the property to or finance the property with any bona fide third party.” Accordingly, the Supreme Court of Iowa reversed the underlying decisions and directed the district court to enter summary judgment in favor of the Landlord.

RADIUS RESTRICTION

The Georgia Court of Appeals has interpreted the language of a radius restriction by applying the general rules of contract construction. The court found that while the language was ambiguous, the restriction was not overly broad and was enforceable. *Fab’rik Boutique, Inc. v. Shops Around Lenox, Inc.*, No. A14A0937 (Ga. App., September 8, 2014).

The parties in this case were Shops Around Lenox, Inc. (“Shops”), the owner of a shopping center, and Fab’rik Boutique, Inc. (“Fab’rik”), a tenant in that center. In late 2009 the parties entered into a three-year lease. The lease required Fab’rik to operate its business (as a women’s clothing and accessories store) under the trade name “Fab’rik.” The lease included a radius restriction that prohibited Fab’rik from opening or operating “another store” within five miles of the leased premises without Shops’ prior consent; the lease further provided that Shops could withhold its consent in its “sole, absolute, and unfettered discretion,” and that a breach by the tenant of the radius restriction would be an immediate default.

The lease included an option to extend the term for three additional years. When Fab'rik attempted to exercise the extension option, Shops contended that Fab'rik was in default because it had opened two other stores within a five-mile radius of the leased premises. Fab'rik filed an action seeking a declaratory judgment that it was not in default under its lease with Shops and was therefore entitled to exercise its extension option.

The trial court granted summary judgment to Shops, construing the radius restriction to apply to the opening or operation of other stores selling women's clothing and accessories under the "Fab'rik" tradename and finding that the restriction was reasonable. Fab'rik appealed, arguing that contrary to the trial court's interpretation, the radius restriction unreasonably prohibited Fab'rik from opening or operating a store of *any* type, not just a women's clothing and accessories boutique operating under the "Fab'rik" trade name.

The appellate court analyzed traditional principles of contract construction, noting that] the court must first decide whether the language in question is clear and unambiguous; if so, then the court must simply enforce the contract according to the clear and unambiguous terms. However, if the contract language is ambiguous in some respect, then the court must apply the rules of contract construction to resolve the ambiguity. If the ambiguity remains, the issue must be resolved by a jury.

Fab'rik argued on appeal that the provision in its lease unambiguously prohibited it from opening a store of any type, based on the perceived generality of the word "store." However, the appellate court opined that the "plain language" of the radius restriction was not that broad but only prohibited Fab'rik from opening or operating "another store," stating that the language of the lease, "on its face, does not unambiguously provide for the expansive restriction asserted by Fab'rik." The court continued its analysis by noting that the lease "as a whole addressed a specific type of store." Further analyzing applicable Georgia law, the appellate court concluded that the restriction was not only reasonable in duration, area and scope, but also affirmed the judgment of the trial court in favor of Shops.

RECIPROCAL EASEMENT AGREEMENT AND SITE PLAN ISSUES; REDEVELOPMENT OF A SHOPPING CENTER

The U.S. Court of Appeals for the Fourth Circuit has reviewed issues raised by the redevelopment of an existing shopping center, balanced against the rights of an anchor tenant; the court denied the anchor tenant's requests for injunctive relief. *Lord & Taylor, LLC, v. White Flint, L.P.*, No. 13-2548 (U.S.C.A. 4th Cir. March 4, 2015).

Lord & Taylor, LLC ("Lord & Taylor") operated a retail store connected to an enclosed shopping mall in Maryland. The mall opened in 1977 and operated for many years, but in recent years it experienced a decline in business. The mall and certain adjacent properties, including the Lord & Taylor site, were subject to a reciprocal easement agreement (the "REA"), which restricted most of the property to retail purposes and required Lord & Taylor's consent to the construction of additional structures as well as any changes in architectural design or appearance.

Beginning in 2011, White Flint, L.P. ("White Flint"), the owner of the mall property, proposed a redevelopment of the property into a mixed-use project. In connection with the proposed redevelopment, the Lord & Taylor store would remain, but the enclosed mall would be demolished and internal roadways and parking areas would be reconfigured.

Lord & Taylor objected to White Flint's plans, negotiations reached an impasse, and in 2013 Lord & Taylor filed an action seeking a declaratory judgment stating that the REA precluded White Flint from redeveloping the mall property as contemplated. The declaratory action also required White Flint to continue operating a first-class high fashion retail center as contemplated by the REA. It is worth noting that, according to the court's opinion, occupancy of the mall and adjacent properties steadily declined, and by January 2015 only the Lord & Taylor store remained open for business.

The district court ruled against Lord & Taylor. While it assumed for purposes of its decision that Lord & Taylor could show that the proposed redevelopment would breach the REA, and that Lord & Taylor could be entitled to damages for any resulting harm, it concluded that injunctive relief would not be feasible under the circumstances. Because of physical changes to the property (including the demolition of another anchor store building) and a 75 percent vacancy rate at the time of the district court's decision, the court reasoned that an injunction requiring White Flint to operate the type of shopping center contemplated by the REA would require the court to supervise a massive task "outside its competence."

The court of appeals agreed that it must consider practical reality. The court, applying applicable Maryland law, commented that

[r]estoring the Mall to its former glory, as Lord & Taylor requested in Count II of its complaint, would have required more than a negative prohibition on the site's redevelopment. It would have necessitated an affirmative injunction ordering White Flint to transform the now-fading Mall back into a 'first class high fashion regional retail [s]hopping [c]enter' - the kind of order that is so hard to draft with specificity and then to enforce that Maryland courts generally will grant it only as a last resort.

The court continued, noting that injunctive relief was particularly impractical due to the highly detailed nature of the REA, because an order that White Flint abide by the REA would require judicial oversight of

compliance with the myriad of REA conditions that control every facet of the Mall's operations, from the distribution of parking and interior access roads to the placement of entrances to the design of the various retail stores and restaurants that populate the Mall.

Moreover, the court's responsibility would continue, as it would have to ensure continued compliance for the duration of the REA, which was potentially for over 40 years.

The court also declined to adopt Lord & Taylor's alternative argument for a more limited, negative injunction that simply prohibited White Flint from moving ahead with the destruction of the mall and parking areas, noting that

[a]gain, we must attend to the realities of the situation facing the district court. A negative injunction, as the court understood, would freeze in place a vacant and partially demolished Mall, tantamount to a judicially mandated blight on the area. That outcome would serve neither party to the dispute, let alone the interests of the general public.

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Exclusivity Clauses in Québec

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Québec courts, which are similar to those of common-law Canada, are mindful of the following general principle in matters of commercial exclusivity covenants: The rule is free trade; the exception is restricting free trade. Therefore, exclusivity clauses are to be construed narrowly since they are an exception to the general rule.¹

Québec, unlike the rest of common-law Canada, is under civil law. The *Civil Code of Québec* (“CCQ”) not only provides for clear rules when interpreting contracts,² but also imposes good-faith obligations, as provided for in Articles 6, 7 and 1375 of the CCQ:

6. Every person is bound to exercise his civil rights in good faith.
7. No right may be exercised with the intent of injuring another or in an excessive and unreasonable manner, and therefore, contrary to the requirements of good faith.
- [. . .]
1375. The parties shall conduct themselves in good faith both at the time the obligation arises and at the time it is performed or extinguished.

As a result, under Québec law, the obligation of good faith is an explicit statutory obligation. Québec law codifies the principle of acting in good faith during the formation and term of the contract.³ Québec law also allows, under certain circumstances, evidence relating to pre-contractual negotiations between the parties to be introduced into court,⁴ which enables the courts to determine the true intent of the parties when negotiating and drafting provisions such as exclusivity clauses.⁵

The Québec courts have rendered a total of seven judgements dealing with exclusivity clauses since 2010. Two of these judgements were rendered by the Court of Appeal: *Indigo Books & Music v. Immeubles Régime XV Inc. et al.* and *Summum Nutrition Inc. (EZ Games) v. Riocan Holdings (Québec) Inc.*,⁶ In Québec, the Court of Appeal makes law.

The Québec Superior Court, which is the first-level tribunal, decided on the most recent cases: *Laplante v. Immeubles Robin Inc.* (Quebec Superior Court—2014) (*Laplante*) and *403-9971 Canada Inc. v. Place LaSalle Property Corporation and Les Entreprises Énergie Cardio Inc.* (Quebec Superior Court—2014) (*Gym*). Both *Laplante* and *Gym* refer to the guidelines set forth in the Court of Appeal appeal judgements in *Indigo* and *EZ Games*. Let us examine these in more detail.

The Laplante Case

Laplante concerned the meaning of terms “principal” and “ancillary use.” Namely, what did the parties seek to protect and what did they seek to permit? The case illustrates how the intention and actions of the parties during the negotiation of a lease, in addition to their actions further to its execution, can influence the court’s interpretation of exclusivity clauses. The facts of *Laplante* bear a striking resemblance to those of *EZ Games*.

Facts

The tenant, a video rental store, and the landlord signed a lease in 2004 for the operation of a video store in one of the defendant’s buildings. The lease contained an exclusivity clause (the “Laplante Exclusivity”) that reads as follows (authors’ translation and underlining):

The Tenant shall have the exclusivity of a video club (i) in the building where the premises are located and (ii) the Landlord covenants, during the term of this lease, to not lease space for a business **whose principal activity** is the **renting of movies** in another building known as the “Centre d’achat Douville” located at 5415-5445 Laurier Boulevard, St-Hyacinthe.

The tenant claimed that the granting of the Laplante Exclusivity was an essential condition due to the proximity of the Centre d’achat Douville (the “Shopping Centre”) from its premises; both properties were owned by the landlord. In 2006, a representative from the landlord contacted the tenant to inform him that the grocery store operating in the Shopping Centre would soon allow, by way of sublease, a video store franchise to operate in the grocery store [premises by installing an automatic movie dispenser machine (the “Video Store Franchise”).

The Video Store Franchise effectively opened its doors to the public in 2006 in an area in the grocery store that was segregated for that specific purpose, and was further identified by a sign on which its logo distinctly appeared. Customers could either access the Video Store Franchise through the grocery store or from the outside of the Shopping Centre without having to enter the grocery store.

In 2007, following unsuccessful negotiations with the landlord to enforce the Laplante Exclusivity, the video store tenant filed a lawsuit against the landlord for damages, a reduction in future rent and punitive damages as a result of the breach of the Laplante Exclusivity.

The landlord claimed that the principal activity of the grocery store within its own premises still remained for the sale of food products and that the Video Store Franchise only occupied a small portion thereof—i.e., an automatic movie dispenser.

In 2008, the landlord and Laplante renewed the term of the lease for one additional year on the same terms and conditions, except that the reference to the Shopping Centre was deleted, thus limiting the scope of the Laplante Exclusivity to the building where the tenant's premises are located.

The Video Store Franchise closed its doors in 2009. During the same year, the tenant and landlord further renewed the term of the lease for one additional year on the same terms and conditions, except that the Laplante Exclusivity was deleted in its entirety.

Analysis

The main issue to be resolved was: Did the defendant violate the Laplante Exclusivity? The court reasoned that the landlord's argument could not be accepted—that is, that the opening of the Video Store Franchise within the grocery store's premises did not change the principal activity of the grocery store. In the eyes of the general public, the Video Store Franchise is located in distinct premises within the Shopping Centre, as evidenced by its own signage and door that could be accessed without entering the grocery store. From this perspective, the Video Store Franchise space and the grocery store space cannot be viewed as a whole [from which one can establish a principal activity. Each space has its own distinct and principal activity.

As the Video Store Franchise's distinct space is used principally for the renting of movies in the Shopping Centre, the defendant is in violation of the Laplante Exclusivity in keeping with the intention of the parties during the negotiation of the lease to protect the plaintiff from the opening of another video store.

The above reasoning by the court is a clear example of the application of Article 1425 of the CCQ, which states that "the common intention of the parties rather than adherence to the literal meaning of the words shall be sought in interpreting a contract."

The court queried: If the intention of the parties when negotiating the original lease in 2004 was to allow a business such as the Video Store Franchise in the Shopping Centre, why did the defendant agree that the 2009 lease amendment would specifically exclude the Video Store Franchise from the Laplante Exclusivity?

The Québec Superior Court concluded that the Exclusivity was violated.

The Gym Case

The *Gym* case concerned establishing the common intent of the parties. *Gym* highlights how the intentional exclusion of a term used in a prior lease was used by the court to determine the meaning that both parties wanted to give to the new exclusivity clause.

Facts

The tenant signed a lease in 2002 with a prior landlord for the operation of a "Ladies fitness centre and weight loss centre" in the landlord's shopping centre. The lease provided that the landlord agreed not to lease to another party for "the principle business of a ladies fitness centre or any fitness centre, which admits women," but that the landlord could lease space to a "men's fitness centre" (the "Original Exclusivity").

While the lease was still in force, the tenant and the purchaser of the shopping centre, Place LaSalle Property Corporation (the "Defendant Landlord"), began negotiations for a new lease. A new lease was eventually signed, which contained the following exclusivity: "The landlord shall not lease or permit any other space in the Shopping Centre to be operated or used principally or in part as a *ladies fitness centre*. (. . .) the landlord shall have the right to lease or permit the occupation of a *men's fitness centre* in the Shopping Centre without contravening the Curves Exclusivity" (the "New Exclusivity"). The Defendant Landlord and Les Entreprises Énergie Cardio Inc. (the "Defendant Tenant") thereafter signed a lease for a mixed-gender gym in the shopping centre.

Before the Defendant Tenant's mixed-gender gym opened to the public, the original tenant (the "Plaintiff Tenant") filed a motion for a provisional injunction—contending that the New Exclusivity only allowed the Defendant Landlord to lease space to a gym that solely allowed admission to men as opposed to a mixed-gender gym.

Analysis

The main issue to be resolved was: Did the defendant violate the New Exclusivity? Referring to two Québec Superior Court decisions rendered since 2010—the *Jean Bleu*⁷ and *Laplante* cases—the court began its analysis by stating that it was mindful of the general principle in matters of commercial exclusivity covenants: The rule is free trade and the exception to the rule is restriction to free trade. Accordingly, exclusivity clauses are to be construed narrowly since they are an exception to the general rule.

The court attempted to determine the true intention of the parties at the time the New Exclusivity was being negotiated. What were the parties essentially trying to protect? At the time, the intent of the parties expressed in the New Exclusivity was to *protect* the plaintiff as the only fitness centre and weight loss centre for women in the shopping centre. The *essence of the protection* was sought to be gender-based in that there could only be one fitness and weight-loss facility that solely admitted women.

The Original Exclusivity was drafted with the intent of protecting the plaintiff against the opening of a ladies-only fitness centre or, alternatively, any fitness centre, which admitted women.

The court highlighted the fact that the Original Exclusivity was still in force while the New Exclusivity was being negotiated between the parties. Therefore, the plaintiff and the Defendant Landlord were aware of the particular wording of the Original Exclusivity, despite the fact that the Defendant Landlord was not a party to the original lease.

The court stated that the plaintiff could have negotiated the same wording used in the Original Exclusivity, with the inclusion of the additional wording “or any fitness centre, which admits women,” which would have extended the restriction to mixed-gender fitness centres.

The court expressly referred to Article 1426 of the CCQ, by stating that a valuable tool for interpretation is the meaning that the parties have already given to the words of a lease by their past actions. The same reasoning was used by the court in *Laplante*, where it looked back at the intent of the parties during the negotiation of a lease amendment that ultimately led to modification of the exclusivity clause language originally used in the lease.

Thus, the past actions of the parties in intentionally excluding the wording “or any fitness centre, which admits women” from the New Exclusivity Clause essentially signalled their intent to allow the Defendant Landlord to lease a mixed-gender fitness centre in the shopping centre.

The court addressed the plaintiff’s argument that the phrase “the landlord shall have the right to lease or permit the occupation of a men’s fitness centre” was intended to limit the Defendant Landlord’s right to lease space to men-only fitness centres. The court referred to another important principle of the rules of interpreting contracts contained in Article 1431 of the CCQ (which was also used in the court’s analysis in the *Jean Bleu* case): “The clauses of a contract cover only what it appears that the parties intended to include, however general the terms used.”

The court rejected the plaintiff’s argument that expressly restrictive words such as “men’s-only fitness centre” are intentionally not used by the parties, who could have easily decided to include them as they modified other portions of the Original Exclusivity.

Furthermore, the court interpreted “men’s fitness centre” as a mere example of a type of fitness centre that may be allowed in the shopping centre due to the fact that a men’s-only fitness centre could never compete with a ladies-only fitness centre. The direct competitor the parties intended to protect was thus a *ladies-only* fitness centre. The Québec Superior Court concluded that the Exclusivity had not been violated.

Lessons To Be Learned

1. Always look at the broader context to ensure that the drafting captures the intent of the parties.
2. Say what you mean and document it. Then, courts can rely on testimony regarding the negotiations leading to the execution of the lease and can proceed with an examination of the written exchanges between the parties.
3. Clearly define the scope and geographical territory of applicability of the exclusivity. Does it apply to the entire centre? Vacant land? A future expansion? Anchor premises?
4. Remember that, with respect to determining principal use, a court can educate itself with information used by a tenant in its own online marketing material.
5. Do not count on making arguments that rely solely on semantics. The courts do not appear to be receptive to word games.
6. Percentage of revenues and inventories used to determine principal use in certain contexts is not applicable in all contexts. Estimations and percentages depend on the factual, contractual and pre-contractual context of each case.
7. Even simply stated, words can lead to ambiguity. Try to make sure that simple words lead to determinate and determinable covenants. Otherwise, a court will seek to “read into the minds of the parties.”
8. Be diligent, and disclose existing exclusives and the consequences of a potential breach.
9. Do not try to do indirectly what cannot be done directly. The courts are not receptive to situations that result in commercial absurdity
10. Good faith is the underlying principle in Québec. One should not attempt to circumvent this principle.

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This article is for general information purposes and is not intended to be, and should not be taken as, legal advice.

¹ *SBI Management v. St-Tropez* [1979], No. A2-51024062 (CA).

² Articles 1425–1432 CCQ.

³ Articles 6, 7 and 1375 CCQ.

⁴ Articles 2863 and 2864 CCQ.

⁵ *Indigo Books & Music v. Immeubles Régime XV Inc. et al.* (Québec Superior Court—2010) (the *Indigo* case) and *Summum Nutrition Inc. (EZ Games) v. Riocan Holdings (Québec) Inc.* (Québec Superior Court—2013) (the *EZ Games* case).

⁶ *Immeubles Régime XV Inc. v. Indigo Books & Music Inc.* (Québec Court of Appeal—2012) and *Riocan Holdings (Québec) Inc. v. Summum Nutrition Inc. (EZ Games)* (Québec Court of Appeal—2014).

⁷ *Jean Bleu Inc. v. Boutique Le Pentagone, Inc.* (Quebec Superior Court - 2011) (“The Jean Blue case”).