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Defaults and Remedies: Drafting for When Your Plans Don't Go According to Plan

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I. Introduction.

When disputes arise between landlords and tenants, the default, remedies, and damage clauses of the lease may matter most. You may think you understand your rights and obligations under your lease, but local law, and the opinions of a judge and jury, can produce unexpected results upon a lease default. This paper digs-in to some common hazards of these clauses, covers some real-life litigation examples, and provides proposed drafting solutions so that your lease dispute is not the subject of the next reported case in your jurisdiction.

II. Basic Landlord Rights

State laws may limit a landlord's rights, regardless of what the lease says. A common thread among many jurisdictions follows the Supreme Court of Appeals of Virginia that held when a tenant abandons leased property during the term, the landlord is permitted, at its option, to either (1) refuse to accept the tenant's surrender and sue for accrued rent, or (2) re-enter the premises and accept the tenant's surrender, thereby terminating the lease and releasing the tenant from further liability on the lease. *Crowder v. Virginian Bank of Commerce*, 103 S.E. 578, 579 (Va. 1920). In other words, when a tenant abandons a lease, a landlord may sue for rent due on the balance of the lease term only if the landlord does not terminate the lease. *Id.* The choice belongs to the landlord. *Id.* ("The landlord [is] under no obligation to resume possession of the premises which [have] been wrongfully abandoned, and ha[s] the right to refuse such possession and to hold the tenant liable under the contract.").

III. Damages Clauses

A. Liquidated Damages

Liquidated damages are fixed damages that the contracting parties designate during the formation of a contract. This pre-determined amount for damages is triggered by a breach of the lease; designed to make the non-breaching party whole. A liquidated damages provision is enforceable if: (1) the circumstances make it difficult or impossible to determine actual damages; and (2) the liquidated damages provision the parties agreed to bear a reasonable relation to the non-breaching party's actual damages. On the other side, the liquidated damages provision is an unenforceable penalty if the fixed damages are: (1) arbitrary and do not bear a reasonable relation to the non-breaching party's actual damages; or (2) exorbitant and unconscionable. Generally speaking, courts will not enforce a liquidated damages provision if the provision is deemed a penalty. In retail leasing, liquidated damages are most often seen as a measure of damages when a tenant that is subject to an operating covenant goes dark, but it can be found in a multitude of circumstances.

B. Rent Acceleration

Commercial leases typically give landlords several rights and remedies when tenants default, including lease termination, eviction, and suits for contract damages. Absent any provision to the contrary, a landlord is entitled to collect rent and any additional charges that accrue under the lease as those amounts become due. Often times, this can be unwieldy as a remedy, and most landlords would prefer to be able to collect the balance of the rent and other charges owed under the lease for the remainder of the term all at once. As a result, most landlords attempt to negotiate a "rent acceleration" clause in their leases. This permits the landlord to declare that all amounts due under the lease for the balance of the term are due and payable immediately upon the occurrence of a default under the lease. Variations of accelerated rent include discounting this amount to present value, reducing this amount by fair market rental value for some or all of the remaining term, or stipulating in the lease that the landlord will be entitled to accelerate rent for some finite period of time immediately following termination.

Tenants often try to eliminate rent acceleration clauses or at least lessen their effects. Rent acceleration clauses can take a number of forms, giving the tenants "credit" for the fact that the landlord will likely have possession of the premises and for the fact that the landlord will be paid the rent all at once as opposed to over time. For example, rent acceleration clauses often provide that the amount to be accelerated is not the full amount of the rent and other charges coming due under the lease, but rather that full amount less the "fair rental value" of the premises for the balance of the term. While this may be objectively fairer (insofar as the landlord does not gain a windfall by re-letting the premises while still getting the full rental from the defaulting tenant for the balance of the term), determining what the "fair rental value" of the premises is can be difficult and can require expert testimony. In addition, rent acceleration clauses will often provide that the accelerated rent will be reduced to "present value" by discounting the aggregate amount by a percentage (since dollars paid now are worth more than dollars paid in the future).

There are many approaches to consider in drafting a reasonable acceleration of rents provision. From the landlord's perspective, including a more balanced clause in the lease could lessen the risk of a court finding the provision unenforceable. This type of approach could also possibly save negotiation time and expense, while still preserving the flexibility and certainty that accelerating-type damages provides. From the tenant's perspective, a true accelerated monetary judgment would be substantial if enforceable, so any reasonable compromises should be welcome. The following drafting tips should be considered when preparing a rent acceleration provision:

(1) Consider when the accelerated rent provision should apply; for example, whether it is limited only to the most serious of defaults or only in the event of the tenant's bankruptcy;
(2) The amount of accelerated rent should either be:
    a. net of the fair market rental value (with fair market value determined through a reasonable, good-faith process) instead of based upon the entire amount payable for the remainder of the term or net of the amounts a landlord could reasonably or does actually gain from any reletting; or
    b. net present value of such future rental stream; and
(3) If the parties agree to a net present value concept, then the discount rate used in such calculation should be a commercially reasonable one.

IV. Lease Termination by Mutual Agreement

By the time a landlord and tenant have decided to terminate a commercial lease, both parties are usually in a rush to go their separate ways. Regardless of the reason a landlord and tenant decide to terminate a lease before its natural end date, early termination raises many common business and legal issues that each party should consider, negotiate, and then memorialize in a written agreement.

The most common business issue to resolve is whether either party must make a special payment to the other party in exchange for the early termination. While it is usually the tenant that pays the early termination fee, sometimes circumstances arise in which it is the landlord that wants to "buy its way out" of the lease early. Unless the lease provides for an agreed-upon termination fee, the determination of the proper early termination fee expected from a tenant will typically reflect a number of considerations, including the remaining term of the lease, whether the tenant still owes any back rent, the amount and status of any remaining security deposit or prepaid rent, the unamortized costs the landlord originally incurred for any tenant build-out, broker commissions, rent concessions, and costs the landlord anticipates incurring as a result of getting the space back early. If a tenant is paying a lease termination fee, the parties should explicitly state in the lease termination agreement when it must pay such a fee and whether, upon receipt of the fee, the landlord otherwise waives all other payments that the tenant may owe under the lease.

A lease termination agreement should also cover the timing and manner of the tenant's departure. Both parties should carefully review the applicable provisions in the underlying lease that describe the tenant's obligations before surrendering the space to the landlord. For example, following the closure of a failed business, the landlord may be in a better position than the tenant to remove any trade fixtures, signage and abandoned property from the vacated space, and those considerations should be factored-in to the cost of any required repairs the landlord may have to incur when negotiating the early termination fee.

As another example, it may be beneficial for both parties to allow a tenant to continue operating its business in the leased space for a time period following the signing of a lease termination agreement in order for the tenant to sell inventory or wrap up operations. In such a scenario, a landlord will typically want to negotiate the right to actively market the space (and allow prospective tenants to visit) before the date when the tenant is obligated to surrender the space, and the landlord may even want the right to force the tenant to vacate the premises even earlier in order to accommodate the timing requirements of the replacement tenant.

In the event a tenant does not meet its obligations for surrendering the space or otherwise defaults under the terms of the lease termination agreement, the landlord should ensure that the lease termination agreement expressly provides the landlord with the right to exercise all legal and equitable remedies against the tenant (or against the guarantor). In addition, if the parties agree that the landlord will return a security deposit to the tenant in connection with the termination of the lease, the landlord should specify in the lease termination agreement that the landlord has the right to use some or all of the security deposit to cover the cost of removing the tenant's personal property from the space or repairing any damage to the space.

Another key legal issue that can complicate early termination discussions is whether and the extent to which each party will release the other from any existing or future claims and liabilities arising from the terminated lease. In considering whether to give such releases, the parties should remember that typically no additional releases would have been given by either party had the lease expired in the normal course. For example, unless there are unusual circumstances, the landlord should release the tenant from any existing or future claims resulting from any tenant defaults. Similarly, the tenant should usually release a landlord from any claims resulting from an alleged default on the part of the landlord. Certain categories of claims should be excluded from the waiver and release provisions, however. For example, neither party should agree to release the other from a claim resulting from a breach of an obligation by either party under the terms of the lease termination agreement itself. In addition, to the extent the underlying lease includes indemnity obligations that expressly survive the expiration of the lease term, such as an agreement by the tenant to indemnify the landlord for environmental liabilities, those specific indemnifications should remain in effect following lease termination.

V. Landlord Self Help/Reentry

"Self-help," in a leasing context, typically refers to the landlord's traditional remedy of locking out the defaulting tenant and taking back the premises without going through the judicial system. Historically, under the common law, a landlord was free to choose its remedies against a defaulting tenant with few limitations, including the liberal use of self-help. However, modern jurisprudence generally provides tenants with much greater protection from eviction and also seeks to prevent possible violent landlord-tenant confrontations.

Therefore, the majority of states have now abolished the traditional rule of self-help, and permit landlords to evict tenants only through court proceedings. In connection with the move away from self-help, most states have established summary eviction proceedings and dedicated landlord-tenant dockets which, in theory, provide landlords with a more efficient and expedient method of retaking possession than traditional civil litigation.

Even with respect to those states that continue to recognize a landlord's right to self-help, attorneys should be reluctant to recommend this remedy for their landlord-clients, given: (1) the exposure for significant liability to the tenant if the tenant has a valid defense to the alleged default or other damages are incurred in the process of exercising self-help; (2) the availability of summary ejectment proceedings; and (3) the often correct perception that courts take a dim or outright hostile view toward self-help. Further, in the minority of states that still permit a landlord to exercise self-help, the remedy is often limited to commercial landlords, as residential tenants are afforded much greater protection.

VI. Landlord Duty to Mitigate.

When faced with a claim for damages, tenants often argue that the landlord should not recover the damages sought because the landlord did not make reasonable efforts to mitigate its damages. In a minority of states, a landlord has no duty to mitigate damages. But in most states, a landlord must make a reasonable effort to mitigate damages, and recovery of rent may be limited to any deficiency between the rent secured through reasonable mitigation efforts and the rent that was otherwise due for the remainder of the lease term. See *Allen v. Harkness Stone Co., Inc.*, 271 Ga. App. 397, 609 S.E.2d 647 (2004), *cert. denied*, (May 23, 2005); *Holiday Furniture Factory Outlet Corp. v. State, Dept. of Corrections*, 852 So. 2d 926 (Fla. Dist. Ct. App. 1st Dist. 2003); *Holy Properties Ltd., L.P. v. Kenneth Cole Productions, Inc.*, 87 N.Y.2d 130, 637 N.Y.S.2d 964, 661 N.E.2d 694, 696 (1995); and *Marvin Hewatt Enterprises, Inc. v. Butler Capital Corp.*, 761 S.E.2d 857 (Ga. Ct. App. 2014). Thus, the duty to mitigate can be used by a tenant to delay a final decision, drive up legal costs, and ultimately eliminate a portion or all damages sought.

A landlord with a duty to mitigate should be ready to show its work. A landlord should take actions that show an effort and desire to find a new tenant, including hiring a real-estate agent or broker, advertising the premises for rent, showing the premises to prospective tenants, and keeping the premises in a showable condition. Courts will also consider circumstances like the landlord's failure to relet the premises to a prospective tenant or failure to repair or maintain the premises following abandonment into the analysis.

Courts look to the facts and circumstances of the case to determine whether the landlord fulfilled his duty to make reasonable efforts to mitigate damages by finding a replacement tenant. In a New Jersey case, the court considered the entire history of the dispute between the landlord and former tenant, and while the court found sufficient mitigation of damages in the first two complaints, as time passed, the court found that the lack of electricity, minimal signage, and a lack of evidence showing the landlord advertised the property as signs that the landlord had not sufficiently mitigated damages. *Fanarjian v. Moskowitz*, 237 N.J. Super. 395, 568 A.2d 94 (App. Div. 1989). *C.f. Bernstein v. Seglin*, 184 Neb. 673, 171 N.W.2d 247 (1969) (landlord's failure to rent abandoned premises to prospective replacement tenant did not constitute failure to use reasonable efforts to mitigate damages where prospective tenant did not make concrete offer to lease); *Connecticut General Life Ins. Co. v. Melville Realty Co., Inc.*, 591 So. 2d 1376 (La. Ct. App. 4th Cir. 1991) (lessor's efforts to relet were reasonable despite ultimate failure to relet premises, where lessor found prospective tenant at time when market was very soft and failed to relet premises to tenant due to lease guarantor's reservation of right to object to proposed rental terms).

How can leases build in more certainty? We recommend the following considerations.

First, consider explicitly addressing whether landlord is subject to the duty to mitigate, even if they are only entitled to recover the balance of rent less the fair market rental value of the property. For example, an Illinois court has endorsed a commercial lease provision that waived the tenant's right to have the landlord attempt to relet the property upon the tenant's default despite an Illinois statute that required a landlord to attempt to mitigate damages. There, the court found that the landlord and tenant, as commercial entities, had no disparity in bargaining power, and pointed to the general rule that a contracting party may waive a contractual provision intended to benefit that contracting party in support of its contention that a tenant could contractually waive its statutory right to assert a lack of mitigation of damages. *Takiff Properties Group Ltd. #2 v. GTI Life, Inc.*, 2018 IL App (1st) 171477, 124 N.E.3d 11(App. Ct. 1st Dist. 2018). It remains a jurisdictional question whether parties may waive a tenant's right to assert a failure to mitigate, but a lease provision that provides for a measure of damages will provide clarity and would likely minimize the landlord's risk in the event of default.

Second, consider adding a provision stating that the fair rental value of the premises shall not exceed a certain percentage of the rent balance to build certainty as to what will happen upon default. For example, "*Landlord and Tenant stipulate that the fair rental value of the Premises shall not, in any event, exceed 25% of the then present value of Rent for such period, using a discount rate equal to the lesser of 5% or the prime rate of interest as published by the Wall Street Journal or other national financial publication*."

Third, if a duty to mitigate applies, consider expressing what actions a landlord must take that would satisfy the duty to mitigate. For example, a lease can say "*Landlord shall be deemed to have used reasonable efforts to relet in the event it lists the premises with one of its customary leasing agents for lease and does not discriminate in bad faith against the premises in its dealings with leasing prospects.*" Consider stating that "*the landlord is not obligated to lease the premises to any given prospective tenant*."

VII. Lease Expiration Issues

Common default debates occur with respect to holdover and the condition of the premises at least expiration, which may not necessarily afford the landlord many remedies if the tenant defaults. A landlord seeking to re-tenant space is often put in the position of exposure to its future lessee if the existing lessee fails to timely vacate or leave the premises in the condition the landlord expects to receive it. If a tenant moves-out and abandons property and alterations, and fails to perform repairs to the premises that exceed the standard of "normal wear and tear", landlord's damages can easily exceed any security deposit that it is holding. Likewise, if a tenant holds over in the space, for even a short period of time, it can cause delays in the landlord's ability to relet the space. In these situations, the landlord is often stuck with the only remedy of a suit for damages, because the tenant has either already moved-out or will vacate after a short holdover period.

A. Surrender Requirements

Any commercial lease should clearly delineate what types of property (i.e., alterations, signage, tenant improvements, fixtures, furnishings and equipment) may be removed, must be removed, and must be left in the premises. This is especially important when a landlord performed extensive tenant improvements or provided a substantial TI allowance, and expects to have the benefit of some or all of that investment for subsequent tenants. It is also essential to the landlord's protection when the premises contains certain alterations or FF&E that is specific to a tenant's use and could detract from its value or desirability (e.g., bank vaults, garage pits and lifts, warehouse racking, and storage/containment systems for hazardous substances) or otherwise cost the landlord substantial sums to remove. Anytime that a tenant is doing a highly specialized build-out specific to its use, it is important to consider which items should be required to stay or be removed.

The type of property will often drive this consideration:

- For restaurant space, a fully-fixtured kitchen can be a major benefit to the landlord when seeking to relet the space. Common conditions for surrender of restaurant space include the obligation to leave behind walk-in coolers, the exhaust hood and system (sometimes referred to as "black iron" ductwork), grease traps, and sometimes built-in ranges and ovens.

- For office space, extensive cabling is becoming less of a major issue due to wi-fi internet usage, but any office user should expect to have to remove any cabling in a drop ceiling that it installed for its own use. After several tenants' wiring gets run through a ceiling, the weight can overload the support capacity, putting office landlords in the position to have to pay to have the wiring removed.

- In movie theatre leases, seats, screens, audio systems, and projectors are frequently fought-over, as a typical theatre has limited re-use options for the landlord and if the seats and screens are gone, a replacement tenant has to make substantial investment to restart or continue the theatre use.

When a lease is at the negotiation stage, it can be challenging to determine what items the landlord will want removed or abandoned in place, and what is fair to require the tenant to remove. Beyond simply putting the decision in landlord's discretion, a common way to address the issue is to allow the landlord to reserve the right to declare that specific elements of a build-out remain in place or be removed at the end of a lease term, with the balance of the initial tenant improvements to stay. Future alterations that get done during the lease term present similar issues, with a typical middle-ground resolution being that the tenant must obtain consent to certain alterations, and the landlord may condition its consent upon the tenant being obligated to remove them at the end of the lease term.

A related issue is a tenant's abandonment of personal property (that is likely just a bunch of trash in the landlord's eyes). Courts most commonly have held that a tenant has a reasonable amount of time to remove personal property after the termination of its lease, but whether and when the property becomes "abandoned" is a fact-based analysis. See *Titcomb v. Carroll*, 287 Mass. 131, 191 N.E. 410 (1934); *In re Site for Library in City of Minneapolis*, 254 Minn. 358, 95 N.W.2d 112 (1959); *Mombro v. Louis Capano & Sons, Inc.*, 526 F. Supp. 1237 (D. Del. 1981); Goss v. Bisset, 411 S.W.2d 50 (Ky. 1967); *Milanovich v. Dwyer*, 2004 MT 91N, 322 Mont. 528, 94 P.3d 764 (2004). Case law interpreting abandonment varies, but generally, an essential element for the determination is the intent to abandon. One cannot simply point to a tenant's nonuse – it must be for a continuous, long period without explanation. *See City of Anson v. Arnett*, 250 S.W.2d 450, 454 (Tex. Civ. App.--Eastland 1952, writ ref'd n.r.e.). For example, a commercial tenant who closes their business and leaves the premises, but keeps paying rent, has not abandoned its premises. *See Lucky v. Fidelity Union Life Ins. Co.*, 339 S.W.2d 956, 958 (Tex. Civ. App.--Dallas 1960, no writ). A landlord must permit a vacating tenant to remove their personal property, or run the risk of being liable for conversion. *Johnson v. Northpointe Apartments*, 744 So. 2d 899 (Ala. 1999); *Weicht v. Suburban Newspapers of Greater St. Louis, Inc.*, 32 S.W.3d 592 (Mo. Ct. App. E.D. 2000); *Rinden v. Hicks*, 119 N.H. 811,408 A.2d 417 (1979); *Hayes Oyster Co. v. Dulcich*, 170 Or. App. 219, 12 P.3d 507 (2000); *Cox's Bakeries of North Dakota, Inc. v. Homart Development Corp.*, 515 S.W.2d 326 (Tex. Civ. App.—Dallas 1974, no writ); *Schara v. Thiede*, 58 Wis. 2d 489, 206 N.W.2d 129 (1973). Generally, however, once a tenant has actually abandoned the premises and its property, the landlord may take possession of the tenant's abandoned personal property and dispose of it. *Abbadessa v. Tegu*, 122 Vt. 345, 173 A.2d 581 (1961); *Star Amusement, Inc. v. Strini*, 427 So. 2d 659 (La. Ct. App. 5th Cir. 1983); *Bank of America Nat. Trust & Sav. Ass'n v. Taliaferro*, 144 Cal. App. 2d 578, 301 P.2d 393 (1st Dist. 1956).

There also are various state statutes governing abandoned personal property that may impose specific requirements (e.g., requiring a landlord to provide notice before disposing of the property or penalizing tenants for leaving the property). In Texas, for example, a commercial landlord may dispose of a former tenant's property after a 60-day period and notice to the tenant. Tex. Prop. Code § 93.002(e). Virginia also requires notice that abandoned property will be disposed of, but only 24 hours after termination of the lease, provided that the landlord has also given a 7-day termination notice. Va. Code. Ann. § 55.1-1254.

A final consideration for lease drafters for landlords and tenants alike is to flesh-out what the concept of "reasonable wear and tear" means in specific situations. Reasonable minds can differ about whether worn-out carpet, dings in drywall, non-functional lighting and plumbing fixtures, and worn-down dock bumpers are tenant repair items or normal wear and tear that a landlord should expect after the lease term ends. Best practice is to be specific about such items in the lease negotiations.

B. Holdover

A typical holdover provision will establish that, if a tenant fails to vacate when the lease expires, its base rent will increase by a factor of 125%-200%, and the tenant may either be expressly in default and deemed a tenant at sufferance, or a month-to-month tenancy may be created. A frequent debate arises in these situations over whether the increased rent paid by tenant is liquidated damages for landlord or if the landlord can recover additional damages, and whether those additional damages include consequential damages that landlord incurs if the holdover puts the landlord in breach of its obligations to deliver the space to a new tenant (or in breach of a sale contract requiring the building be delivered vacant to a purchaser). Careful consideration should be made when drafting and negotiating this provision that can often be thought of as "boilerplate" language.

VIII. Litigation v. Arbitration.

One consideration for a lease drafter is whether the parties desire litigation v. arbitration for their disputes. There are pros and cons for both types of dispute resolution – all of which are worthy of consideration at the outset.

Benefits of litigation include: familiarity with the process, broader discovery, availability of jury if that is desired, and availability of appeals including in the event of an adverse ruling. Further, arbitrations are not always cheaper. The parties are responsible for paying the arbitrators' fees and case administration fees, which can be substantial. Arbitrators can be more reluctant to decide motions for summary judgment, but require parties to bring the matter to hearing.

Nonetheless, parties can draft arbitration clauses to minimize time, expense, publicity, and appeals. An arbitration clause should consider the number of arbitrators to decide the dispute, any expertise required of the arbitrator, the location of the arbitration, the limits on discovery, the deadline for the completion of proceedings, length of hearing, the applicable arbitration rules, who will pay for the arbitration, and the (un)availability of appeals. The clause can require confidential proceedings. If arbitration is desired, it should be drafted with specificity, with consideration to the likely disputes, and with the aid of a litigator.