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

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Basic Landlord Rights on Tenant Default

- State laws may limit a landlord's rights, regardless of the lease terms.
  - Generally, when a tenant abandons leased property during the term, the landlord is permitted 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.



- In other words, a landlord may sue for rent due on the balance of the lease term only if the landlord does not terminate the lease.
  - The choice belongs to the landlord.

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Damages Clauses - Liquidated Damages

- Liquidated damages are fixed damages that the contracting parties designate during the formation of a contract designed to:
  - make the non-breaching party whole; and
  - give the parties clarity for when a breach occurs.



Liquidated Damages – Enforceability

- 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.
- A 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.

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Damages Clauses - Rent Acceleration

- A landlord is generally entitled to collect rent and additional charges that accrue under the lease as those amounts become due.
  - This can be impractical, and landlords generally prefer to collect the balance of the rent and other charges owed for the remainder of the term all at once.
- A "rent acceleration" clause permits a landlord to declare all amounts that would be owed under the lease for the balance of the term are due and payable upon default. Example:

> *Landlord may terminate this Lease and recover as damages a sum of money equal to the total of (i) the cost of recovering the Premises, (ii) unpaid Rent earned at the time of termination plus interest thereon at the Applicable Rate from the due date until paid, (iii)* ***the balance of the Rent for the remainder of the Term less the fair market rental value (allowing a reasonable period of reletting) of the Premises for such period, both discounted to their present values at the rate of 8% per annum****, and (iv) any other sum of money and damages owed by Tenant to Landlord.*

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Rent Acceleration – Considerations

- Limiting circumstances when rent acceleration applies – *e.g.*, most serious defaults
- Discounting the rent balance to present value
- Reducing the amount owed by fair market rental value or a stated percentage
  - Determining "fair rental value" can be difficult and can require expert testimony
- Stipulating in the lease that the landlord will be entitled to accelerate rent for only a limited period of time following termination
- Disclaiming that liquidated damages are a penalty

Lease Termination by Mutual Agreement

- Usually this arises where the tenant pays an early termination fee, but landlord may want to “buy its way out” of the lease early.
- Considerations for buyout calculations include:
  - the remaining term of the lease;
  - rent in effect as compared to market rent upon re-letting;
  - 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, and rent concessions;
  - costs the landlord anticipates incurring as a result of getting the space back early;
  - whether there is any value in equipment or personal property that will be forfeited;
  - whether any landlord costs will be incurred for removing trade fixtures, signage, and abandoned property from the vacated space;
  - Landlord’s ability to market the space for re-letting, including immediacy of access and possession; and
  - whether the tenant owes back rent.

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Termination by Mutual Agreement, cont'd

- Consider the scope of releases. Will each party release the other from any existing or future claims and liabilities arising from the terminated lease?
  - Ordinarily, the landlord should release the tenant from any existing or future claims resulting from any tenant defaults.
  - Similarly, the tenant should release a landlord from any claims resulting from any alleged defaults on the part of the landlord.
  - Certain categories of claims should be excluded from the waiver and release (*e.g.*, breach of an obligation under the lease termination agreement and environmental and other indemnity obligations that expressly survive the expiration of the lease term).
- A 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) if the tenant defaults on the lease termination agreement.

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Landlord Self Help/Reentry

- "Self-help" 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.
- Modern jurisprudence generally provides tenants with much greater protection from eviction and seeks to prevent possible violent landlord-tenant confrontations.
  - Most states have abolished the traditional rule of self-help and permit landlords to evict tenants *only* through court proceedings.
  - 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.

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Landlord Self Help/Reentry, cont'd

Even in states that continue to recognize a landlord's right to self-help, there are risks:

(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) potential hostility by courts toward self-help.



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Landlord's Duty to Mitigate

- 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.
- A landlord with a duty to mitigate should be ready to show its work! Landlord should take actions that show a bona fide effort to mitigate, including:
  - Hire a real-estate agent;
  - List and advertise the premises for rent;
  - Repair and keep the premises in a showable condition;
  - Show the premises to prospective tenants; and
  - Re-let the premises if a reasonably acceptable tenant can be secured.



Landlord Duty to Mitigate, cont'd

- How can leases build in more certainty?
  - Consider explicitly addressing whether landlord is subject to a duty to mitigate.
  - 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 then-current prime rate of interest as published by the Wall Street Journal or its successor publication*."
  - If a duty to mitigate applies, consider expressing what actions a landlord must take that would satisfy the duty to mitigate.
    - For example: "***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.* ***Landlord is not obligated to lease the Premises to any given prospective tenant***."

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Landlord Duty to Mitigate, cont'd – Cases

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.

Court considered: (1) how landlord and tenant were commercial entities with no disparity in bargaining power; and(2) the general rule that a contracting party may 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).

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Landlord Duty to Mitigate, cont'd – Cases

- Reasonableness
  - While a New Jersey court found sufficient mitigation of damages in the beginning, it concluded that as time passed 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).
  - 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. *Bernstein v. Seglin*, 184 Neb. 673, 171 N.W.2d 247 (1969).
  - 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. *Connecticut Gen. Life Ins. Co. v. Melville Realty Co., Inc.*, 591 So. 2d 1376 (La. Ct. App. 4th Cir. 1991).

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Surrender Defaults

- Leases 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.
- End-of-term remedies for landlords are often limited to the security deposit and/or a suit for damages. Consider the function of a "good guy guaranty" for this situation.
- This is especially important when a landlord performed extensive tenant improvements or provided a substantial TI allowance and expects the ongoing benefit of the work.







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Surrender – Removal of Alterations and FF&E

- The type of property will often drive removal considerations:
  - For restaurant space, common conditions for surrender 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, removal of cabling in a drop ceiling and even internal open staircases can be important considerations.
  - For movie theatres, 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.

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Surrender – Removal of Property

- Did the tenant actually abandon the property?
  - Generally, requires an intent to abandon, which consists of definite acts showing that intent.
  - Courts commonly hold that a tenant has a reasonable amount of time to remove personal property after the termination of its lease.
  - Risk is that the landlord is liable for conversion.
- Whether and when the property becomes "abandoned" is a fact-based analysis.
  - Cannot simply point to a tenant's nonuse – it must be for a continuous, long period without explanation.
  - 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).
- Consult state law.
  - Texas: Statute requires 60-day notice to tenant before disposing property.
  - Virginia: Statute requires 10-day notice to tenant after lease expiration before disposing tenant property.
- Consider lease provisions.
  - "*All leasehold improvements and alterations remaining in the Premises at the end of the Term or upon abandonment of the Premises shall become the property of Landlord and shall be surrendered to Landlord.*"
  - Landlord shall "*recover any cost involved with storing or removing Tenant's property*" left after a lease term or upon default

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Surrender – Reasonable Wear & Tear

- Landlords and tenants should establish agreement on what constitutes “reasonable” wear and tear.
- 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.









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Surrender – Reasonable Wear & Tear, cont'd

Examples of acceptable wear and tear may include:

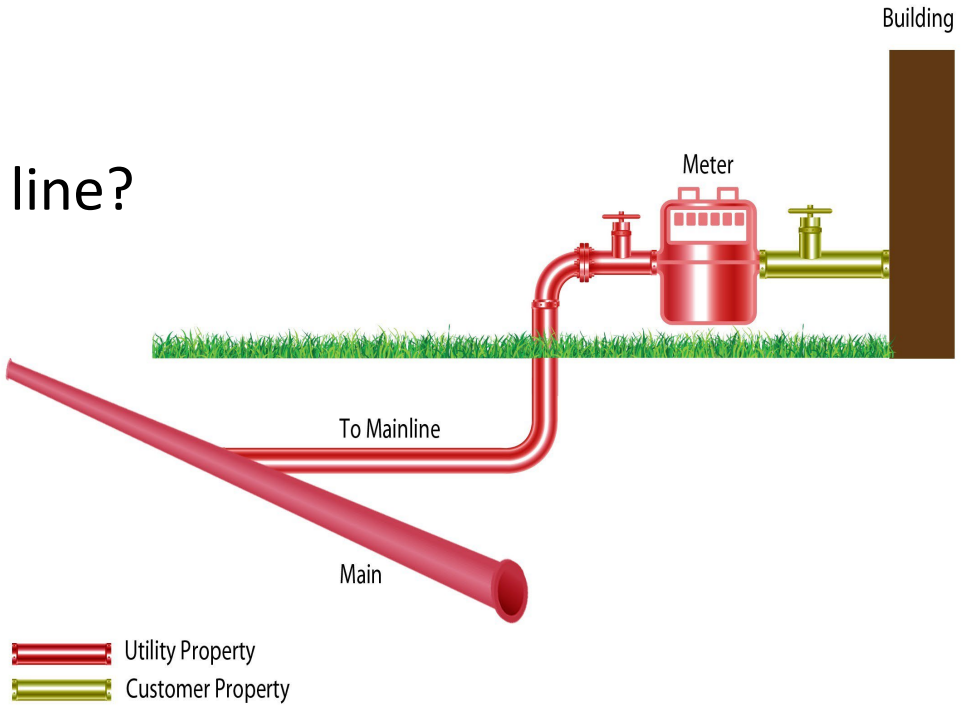
- Faded flooring and paint
- Loose wallpaper
- Worn carpet
- Scuffed hard flooring
- Façade stains from removed signage
- Stained ceiling tiles
- Burned-out light bulbs
- Any damage resulting from landlord neglect

Examples of property damage may include:

- Unauthorized alterations
- Broken windows
- Large holes in the walls
- Ripped or missing window screens
- Broken appliances (stove, toilet, *etc.*)
- Broken or missing blinds
- Stains, tears, and burns in carpet and other flooring
- Any damage resulting from tenant neglect

A Surrender Case Study

- In a commercial lease, tenant is required to have “all utilities and utility meters disconnected.”
- Does this require:
  - Disconnecting gas service?
  - Having the utility remove its gas line?



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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 tenant.
- 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).

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Litigation v. Arbitration

Arbitration	Litigation
<u>Pros</u> • Ability to draft limits on time and expense • Can specify arbitrator expertise • Can be confidential	<u>Pros</u> • Process is typically well-understood by both sides • Discovery allowed may be broader • Availability of a jury, if that's desirable • Availability of appeals
<u>Cons</u> • Reluctance to decide motions for summary judgment • Not always cheaper, parties responsible for paying arbitrator fees/administration • Risk in how arbitrators are chosen • Discovery may be more limited • Limited appellate rights • Arbitrators often try to “split the baby”	<u>Cons</u> • Often takes longer than arbitration • While not always the case, it can be more expensive than arbitration • Judge may have no subject matter expertise • You may be stuck with a jury

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Arbitration Drafting Considerations

- Number of arbitrators
- Any expertise required of arbitrators
- Limits on discovery
- Location of arbitration
- Deadline for completion of proceedings
- Length of hearing
- Applicable arbitration rules
- Who will pay
- (Un)availability of appeals



Questions?

Thank you for attending!

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