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Seminar 6

Landmark Decisions: The Defining Cases You Need to Know

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The Modern Commercial Lease

Leases are Contracts:

Wesson v. Leone Enter., 774 N.E.2d 611 (Mass. 2002)

"In this case, we abandon the common-law rule of independent covenants in commercial leases in favor of the modern rule of mutually dependent covenants as reflected in the Restatement (Second) of Property (Landlord and Tenant) s. 7.1 (1977)."

Out with the Old

The Independent Covenants Rule:

- “Promises made by a landlord were independent obligations, so that the failure of the landlord to perform them did not give the tenant any right to disregard his obligations under the lease.” Restatement (Second), Introductory Note, c. 7 (1977)

- Rule “based on the assumption that a lease is primarily a conveyance of an interest in real estate and reflected the parties’ expectation in a rural agrarian society where the right to possession of the land constituted the chief element of the exchange.”

In with the New

The Mutually Dependent Covenants Rule:

- “Except to the extent the parties to a lease validly agree otherwise, if the landlord fails to perform a valid promise contained in the lease to do, or to refrain from doing, something … as a consequence thereof, the tenant is deprived of a significant inducement to the making of the lease, and if the landlord does not perform his promise within a reasonable period of time after being requested to do so, the tenant may (1) terminate the lease.”

- Rule “comports with the reality of the typical modern commercial lease, which is intended to secure the right to occupy improvements to the land rather than the land itself, and which usually contemplates a continuing flow of necessary services from landlord to tenant.”

Implications

- Tenant does not need to prove constructive eviction to exercise remedies.

- Failure to perform a promise ***to do***:

  e.g., maintain the roof

- Failure to perform a promise to ***refrain from doing***:

  e.g., agreement not to lease space to competing business

But …

- ❖ Leases are contracts.
- ❖ Parties may "validly agree otherwise."
- ❖ They often do.

“Parties are to be held to their words”:

Cummings Prop. v. Hines, 217 N.E.3d 604 (Mass. 2023)

“The general rule of our law is freedom of contract and it is in the public interest to accord individuals broad powers to order their affairs through legally enforceable agreements. This is so even where, as here, the enforcement of the contract appears to produce harsh results.”

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Liquidated Damages

- “So it is with liquidated damages clause.”

- “It has long been the rule in Massachusetts that a contract provision that clearly and reasonably establishes liquidated damages should be enforced, so long as it is not so disproportionate to anticipated damages as to constitute a penalty.”

Rent Acceleration Clauses

If LESSEE defaults in the payment of any rent, and such default continues for 10 days after written notice thereof … then, in addition to any other remedies, the net present value of the entire balance of rent due … shall immediately become due and payable as liquidated damages, since both parties agree that such amount is a reasonable estimate of the actual damages likely to result from such breach.

“First” vs. “Second” Look Jurisdictions

First Look:

❖ At the time the contract is formed

❖ Promotes certainty, resolves disputes efficiently, avoids litigation

❖ Mitigation irrelevant

“We never had required that the amount of a liquidated damages clause take into account any future rents collected from a new tenant to be enforceable.”

Second Look:

❖ At the time of the breach

❖ Promotes litigation over that which parties sought not to litigate

Implications

- Rent acceleration clauses are enforceable.

- Even if landlord subsequently relets the space and receives replacement rent.

- Are you in a “first look” or “second look” jurisdiction?

Contracts have Meaning:

122 East 42nd Street, LLC v. Joseph Scharf, et al.
211 A.D.3d 617 (1st Dep’t 2022)

“The motion court properly determined that reading the 'whereas” clause in the guaranty to incorporate the terms of the lease did not create an additional right but merely reflected the fact that the guaranty and the lease contained interrelated obligations.”

“The tenant was obligated under the lease to obtain plaintiff's written consent in order for the surrender to be valid, which plaintiff established as a matter of law did not occur here.”

What did this Lease require for surrender?

- Trial court entered a judgment against the *guarantor* in the sum of $1,273,299.36, for the *tenant's* failure to properly surrender.
- Article 22 ("End of Term"): "Upon the expiration or other termination of the term of this lease, Tenant shall quit and surrender to Owner the demised premises, broom clean, in good order and condition, ordinary wear and damages which Tenant is not required to repair."
- Article 25 ("No Waiver"): "No act or thing done by Owner or Owner's agents during the term hereby demised shall be deemed an acceptance of a surrender of said premises, and no agreement to accept such surrender shall be valid unless in writing signed by Owner."
- Is a guarantor bound by these obligations?

Implications

- Tenant failed to affirmatively seek landlord's prior written consent to surrender, which contributed to the Court's decision.
- Lease language may require tenant to obtain consent in order to surrender, but that requirement should not be imputed to the guarantor.
- A tenant under a good guy guaranty should least attempt to secure a landlord's consent, and if a landlord withholds the same, tenant can argue Landlord did so in bad faith.

Contracts have Meaning Continued:

Empire LLC v. Sharapov, 192 A.D.3d 417 (1st Dep't 2021)

"On reargument, the court properly determined that the guaranty provided that defendant would be absolved of liability for obligations under the guaranty only upon, *inter alia*, a valid surrender."

"Because there was no written surrender in compliance with the lease, or compliance with the terms of the guaranty concerning surrender, there was no valid surrender, and defendant was liable for the remainder of the rent."

Does an eviction count as a "surrender"?

- In *Empire LLC*, the landlord commenced a separate action against guarantor for damages following a landlord-tenant proceeding evicting the tenant. The trial court found that the guarantor remained liable for the period following the eviction and until the premises was re-let.
- Trial court noted: "A 'nonpayment dispossess proceeding' does not, alone, 'evidence[ ] a surrender of the demised premises operating to release [a] defendant from continuing liability under the lease.'"

Implications

- Defendant guarantor here <u>never raised a defense of surrender in his answer</u>, nor did he oppose the subject motion by landlord to reargue.
- Any tenant in a similar situation should raise a defense of surrender in opposition to a plenary action for damages after the post-surrender period.
- Doing nothing and waiting for eviction can result in a court not applying the protections of a good guy guaranty.

Constitutional (and Statutory) Constraints

Transformation of the Shopping Experience

U.S. v. Parke, Davis and Co., 80 S.Ct. 503 (1959)

- ❖A pharmaceutical company published suggested minimum prices for retailers and tried to enforce uniform compliance from retailers with these guidelines after some retailers began advertising and selling Parke Davis vitamins at a discounted price.

- ❖SCOTUS held that, by taking "affirmative steps to achieve uniform adherence" rather than "relying on individual self interest to bring about general voluntary acquiescence", Parke Davis violated the Sherman Act.

Transformation of the Shopping Experience

U.S. v. Parke, Davis and Co., 80 S.Ct. 503 (1959)

- Prior to *Parke*, retailers competed on the shopping experience, because they often sold the same goods from the same manufacturer for the same price.
- *Parke* made vertical price schemes very difficult to enforce, which led to retailers being able to compete on price even with the same goods from the same manufacturer.
- With this increased price competition, retailers shifted away from competing on the shopping experience to competing on price and convenience.

Free Speech and Private Property

Pruneyard Shopping Center v. Robins, 447 U.S. 74 (1980)

- ❖The shopping center's regulations prohibited any visitor or tenant from engaging in publicly expressive activities on the property that are not directly related to its commercial purposes. The policy was strictly enforced in a non-discriminatory fashion.

- ❖A group of high school students peacefully set up a table in the central courtyard of the shopping center and asked passing individuals to sign their petition. There was no record of complaints from patrons.

- ❖Security asked the students to leave and suggested relocating to a nearby public sidewalk.

Pruneyard - California Supreme Court

- California's Supreme Court held that the state's constitution protects "speech and petitioning, reasonably exercised, in shopping centers even when the centers are privately owned."

- "It bears emphasis that we do not have under consideration the property or privacy rights of an individual homeowner or the proprietor of a modest retail establishment… 25,000 persons are induced to congregate daily to take advantage of the numerous amenities offered by the [shopping center]. A handful of orderly persons soliciting signatures and distributing handbills… under reasonable regulations adopted by [the owner] to assure these activities do not interfere with normal business operations would not markedly dilute the [owner's] property rights."

Pruneyard - SCOTUS Precedent

❖ In *Lloyd Corp. v. Tanner*, 407 U.S. 551 (1972), SCOTUS evaluated whether, under the federal Constitution, a privately owned shopping center may prohibit the distribution of handbills when such activity is unrelated to the shopping center's operations.

❖ In *Lloyd*, SCOTUS rejected that the First Amendment prevents a private owner from enforcing a handbilling restriction at a shopping center.

❖ "When a shopping center owner opens his private property to the public for the purpose of shopping, the First Amendment does not thereby create individual rights in expression beyond those already existing under applicable law."

❖ SCOTUS distinguished this from *Pruneyard*, noting that, unlike *Lloyd*, *Pruneyard* has an "applicable law".

Pruneyard - SCOTUS Holding

- Not a taking (Fifth Amendment) or a deprivation of property without due process (Fourteenth Amendment)
  - States are bound by the Just Compensation Clause, but the shopping center owner never demonstrated that the "right to exclude others" is so essential to the use and economic value to amount to a taking.
  - No evidence the activity would unreasonably impair the value or use of the property as a shopping center.
  - The shopping center could "restrict expressive activity by adopting time, place, and manner regulations that will minimize interference with is commercial function."
- Not forced speech (First Amendment)
  - "The views expressed by members of the public in passing out pamphlets or seeking signatures on a petition will not likely be identified with those of the owner."
  - The Shopping Center could expressly disavow any connection with the message.

Another State Constitutional Right to Use Private Property:
Batchelder v. Allied Stores Intern., 445 N.E.2d 590 (Mass. 1983)

“We are concerned with the right of a person to solicit signatures in the mall area of a large, private shopping center in support of a candidate’s nomination to public office.”

- Not a right under the U.S. Constitution.
- Not a free speech right.
- A right to solicit signatures for ballot access guaranteed by the Massachusetts Declaration of Rights.
- Right subject to reasonable time, place, and manner restrictions and only in the common areas dedicated to the public.

Reasonable Time, Manner, Place Regulations

- Notice.
- Registration.
- Designated hours.
- Designated areas.
- Evidence of legitimate petitioning activity.
- Limitation on signs, posters, placards, AV equipment.

Economic Development as a "Public Use"

Kelo v. City of New London, 125 S.Ct. 2655 (2005)

- The city approved an economic development plan to revitalize its economy with the intention of creating jobs and increasing property taxes in the area surrounding a new pharmaceutical research facility.

- The city purchased the property of willing owners in the project area and initiated condemnation proceedings against those who refused to sell. A portion of the purchased and taken property would be subject to private development.

- The owners of the taken property challenged this, arguing that the City's use of eminent domain to take property for private development violated the public use requirement in the Fifth Amendment.

Economic Development as a "Public Use"

Kelo v. City of New London, 125 S.Ct. 2655 (2005)

- ❖ SCOTUS held that "public use" was broad enough to encompass the taking of property for private development meant to provide economic benefits to the public.
- ❖ SCOTUS emphasized that the court has a longstanding policy of deference to legislative judgments about what public needs justify the use of the takings power, and the city's determination was entitled to this deference.
- ❖ "Promoting economic development is a traditional and long-accepted governmental function, and there is no principled way to distinguish it from the other public purposes the Court has recognized."

New York City's Unconstitutional COVID-19 Guaranty Law:
Melendez, et al. v. The City of New York, et al.
668 F.Supp.3d 184 (S.D.N.Y. 2023)

"The Court finds that the City has been unable to adduce record evidence demonstrating that the Guaranty Law is reasonably tailored to accomplish its legitimate policy goals. Accordingly… the Court concludes that the Guaranty Law violates the Contracts Clause."

"The contractual impairment imposed by the Guaranty Law on Plaintiffs was substantial…the Court finds that the Law fails to withstand means-ends scrutiny under the final prong of the *Sullivan* test."

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What was the “Guaranty Law” in New York City?

- In response to COVID-19, New York City enacted Administrative Code § 22-1005, entitled “Personal Liability Provisions in Commercial Leases.”
- This law was intended to protect personal guarantors of commercial leases from facing liability for obligations incurred at the early height of the pandemic, between March 7, 2020 and June 30, 2021.
- Plaintiffs, including owners of small commercial and residential buildings in New York City, challenged the Guaranty Law on the basis that it violated the Contract Clause of the U.S.

How did the Court rule?

- In a 33-page decision, Judge Abrams awarded Plaintiffs summary judgment and concluded that the Guaranty law violated the Contracts Clause of the U.S. Constitution.
- Plaintiffs argued that the law violated the Contracts Clause of U.S. Constitution by rendering “guaranty clauses” in commercial leases unenforceable for any unpaid rent during the law’s protected period, while the City of New York argued the law was intended to provide relief for small business owners.
- The Court reasoned that the Guaranty Law posed an “absolute barrier” to a landlord’s recovery of unpaid rent from a personal guarantor, and that doing so represented a “substantial” impairment on a landlord’s right to contract.

Implications

- New York City Landlords may enforce their guaranties against personal guarantors for unpaid rent during the protected period, from March 7, 2020 through June 30, 2021.
- The Guaranty Law no longer protects personal guarantors of New York City lease agreements
- Commercial landlords in New York City can now seek and recover damages against personal guarantors for any obligations incurred during the protected period.

Common Law Constraints

Leases are Contracts, But …

275 Washington St. Corp. v. Hudson River, 987 N.E.2d 194 (Mass. 2013)

"We agree that a commercial lease is a contract rather than a conveyance of property … However, where the contract is a commercial lease, our common law does not provide 'benefit of the bargain' damages in the event of termination of the lease following a breach. Once a landlord terminates a lease, the tenant is no longer obligated to pay rent and, unless the lease otherwise so provides, the landlord is not entitled to posttermination damages."

Common Law Rules

The law as to leases is not a matter of logic in vacuo; it is a matter of history that has not forgotten Lorde Coke. Massachusetts has followed the English tradition and we believe that it is the general understanding in that State that in the absence of statute or express contract that a lessor who has terminated a lease and evicted the tenant has no further claim against the lessee."

Holmes, J.

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Contract Remedies Limited by, and Respond to, Common Law Rules

- Indemnity: Landlord cannot recover under an indemnification clause until the end of the lease term when landlord’s actual loss can be “wholly ascertained.”

- “Parties are free to set forth in a lease when indemnification is due and in what amount.”

- Also free to set forth liquidated damages.

Implications

- "A landlord left without an adequate remedy following breach of the lease by a tenant has only itself to blame for entering into a lease that fails to provide for such a remedy."

- Courts loathe to disrupt the "settled expectations" of negotiating parties. Hundreds of years of common law have put the parties on "fair notice" of what the rules are.

- Understand the background rules against which you are negotiating.

Continuous Operations

Hamilton West Development, Ltd. v. Hills Stores Co., 959 F. Supp. 434 (N.D. Ohio 1997)

"Tenant agrees to use the Demised Premises as a department store or a supermarket (and for no other purpose) and to operate its business in the demised Premises under the name Hills or such other name adopted by Tenant for its self-service department stores in the Cincinnati, Ohio media market, on all regular business days except legal holidays, at least eight (8) hours each day between 9:00 AM and 10:00 PM. Tenant retains the right, in its discretion, to be open on regular business days."

The Lease also granted Landlord the right to terminate the Lease if Tenant discontinued operation of its store in the Demised Premises.

Continuous Operations

Hamilton West Development, Ltd. v. Hills Stores Co., 959 F. Supp. 434 (N.D. Ohio 1997)

- ❖The court concluded that the Lease did not unambiguously impose an obligation that Tenant operate continuously in the Demised Premises during the term and noted that neither party presented evidence from their negotiations to support that they intended to require Tenant continuously operate.
- ❖The court refused to imply a continuous operation covenant.
- ❖The court also highlighted that some courts have refused to specifically enforce continuous operations clauses, because it would require continuing court supervision.

Rule Against Perpetuities

Deer Cross Shopping LLC v. Stop & Shop Supermarket Co., 2 Misc.3d 401 (Sup. Ct., NY County, 2003)

- ❖The initial term was 25 years with 3 successive options to renew for 10 years each.
- ❖If Tenant failed to send its extension notice, Landlord was required to give Tenant notice that it had not timely exercised the option, and Tenant would have 60 days after Landlord's notice to exercise same.
- ❖If Landlord did not provide this notice, the Lease would automatically extend for 60-day periods, subject to termination by Tenant upon 60 days notice to Landlord.
- ❖The Lease also contained a restrictive covenant granting Tenant the exclusive right to operate a supermarket in the center and prohibiting landlord from permitting another entity to operate a supermarket within 2 miles of the shopping center.

Rule Against Perpetuities

Deer Cross Shopping LLC v. Stop & Shop Supermarket Co., 2 Misc.3d 401 (Sup. Ct., NY County, 2003)

- ❖Tenant exercised its first renewal option, closed its store at the shopping center, and opened a new store less than 2 miles away.
- ❖Landlord sought to invalidate the Lease, arguing that the extension options violate Rule Against Perpetuities, and to invalidate the exclusive and radius restriction covenants.
- ❖The court held the options did not violate the Rule Against Perpetuities, because they were appurtenant to the Lease and the lease term could not extend indefinitely (i.e., either Landlord or Tenant could end the automatic 60-day extensions through notice).
- ❖The exclusive and radius restriction were not conditioned on Tenant being open and operating, and therefore, they were valid even though Tenant closed in the Premises and opened a store less than 2 miles away.

The Special Case of Covenants

The Power of "Exclusives":

Winn-Dixie Stores, Inc. v. Dolgen Corp, LLC, et al., 746 F.3d 1008 (11th Cir. 2014)

"Covenants restraining the free use of real property, although not favored, will nevertheless be enforced by courts of equity where the intention of the parties is clear in their creation, and the restrictions and limitations are confined to a lawful purposes and within reasonable bounds."

"Due regard must be had for the purpose contemplated by the parties to the covenant, and words used must be given their ordinary, obvious meaning as commonly understood at the time the instrument containing the covenants was executed."

What is an “Exclusive” in a lease?

- An “exclusive” typically prohibits a landlord from leasing to other tenants who sell certain goods or services that may compete with that tenant’s business.
- Exclusives can be covenants on real property and run with the land.
- State contract law governs the interpretation of restrictive covenants and the enforcement of an “exclusive.”

Implications

- Exclusivity covenants are enforceable but strictly construed.
- Define terms as specifically as possible and understand the state law.
- Think through whether litigation is preferable to a business solution.

The Enforcement of Operating Covenants:

Western and Southern Life Insurance Company v. Crown American Corporation,
877 F. Supp. 1041 (E.D. Kentucky 1993)

"[A prohibition on] the transfer of the property is unenforceable as an unreasonable restraint upon alienation… However, the transferee takes the property subject to the obligation to operate a "retail department store."

"[Defendant] is not excused from its duty of performance of the operating covenant because it decided to close the store for financial reasons… [Defendant] is not excused from its contractual obligations."

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What is an “Operating Covenant”?

- “Anchor tenants” are often the first tenants to sign a lease with a developer or landlord, and are large, well-known businesses intended to help draw customers.
- In formulating a relationship to the operation of a shopping center or mall, parties can memorialize “operating covenants” that require anchor tenants to operate for a certain length of time or for a particular use.
- Transferees of these properties remain subject to the operating covenant.

Implications

- ➢ Broad clauses restricting transfer of property are likely void and represent "an absolute restraint on alienation."

- ➢ Operating covenants are enforceable and can require continuous operation for a particular use – *e.g.*, operating as a "retail department store" for 30 years.

- ➢ An operating covenant would likely not be enforced by way of an injunction, but failure to do so may result in damages.