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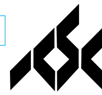

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Shopping Center Legal Update

The legal journal of the shopping center industry

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A Matter of Priorities: Mechanics' Liens and Landlord Indemnity Claims in Retail Tenant Bankruptcies

*Brian D. Huben**
Katten Muchin Rosenman LLP
Los Angeles, CA

The Scenario

Shopping center landlords know it all too well. A prospective tenant expresses interest in leasing space at a shopping center. The landlord considers the prospective tenant a good addition to the tenant mix and balance at the shopping center. Negotiations follow. The tenant wants to build out its prototypical store. A letter of intent is signed. More negotiations. Multiple drafts of the lease are circulated. Perhaps, to close the deal, the landlord decides to give the tenant a construction allowance to offset the tenant's costs of building out the space at the shopping center. The lease is executed. Designs and plans are exchanged and approved. The tenant hires and executes a construction agreement with a general contractor. Permits are pulled. Construction begins. Draws are paid to the general contractor. And then … the tenant files bankruptcy.

The work stops, the payments stop and recordation of the mechanics' liens starts. In many states, even though the landlord has no contractual relationship with the general contractor (or, for that matter, the subcontractors, materialmen or suppliers), the contractors who worked on the construction of the tenant's store nonetheless have a right to record a lien against the landlord's fee simple interest in the property to secure payment for labor or materials supplied as part of the construction, or work of, improvement.

In this scenario, what remedies are available to a landlord?

The Mechanics' Liens

Part of this scenario may seem out of place. Generally speaking, the automatic stay (§ 362 of the Bankruptcy Code) prevents creditors from taking certain actions against the debtor. So, how is it that the contractors are allowed to record mechanics' liens *after* the debtor files its bankruptcy petition? Most courts find that mechanics' liens recorded post-petition to perfect the lien claimants' rights against and interests in the real property for pre-petition work fall within an exception to the automatic stay. *See* §§ 362(b)(3) and 546(b) of the Bankruptcy Code. Moreover, once recorded (i.e., perfected) against the real property, the mechanics' liens are afforded the same priority as they enjoy in accordance with state law. If the debtor/tenant elects to assume the lease, the mechanics' liens must be "cured" (i.e., paid or otherwise satisfied or released). *See* § 365(b) of the Bankruptcy Code.

However, if the debtor/tenant rejects the lease, there is no cure obligation, and the debtor/tenant "walks away" from the construction project. Until recently, that meant the landlord would be left to settle with the lien claimants directly and relegated to the class of unsecured creditors to seek reimbursement for the settlements payments—often recovering from the debtor/tenant only a fraction of what was paid to settle the mechanics' liens.

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The *Mervyn's Holdings* Case

In July 2008, Mervyn's LLC and various affiliates (collectively, the "Debtors") filed Chapter 11 in Delaware. Prior to the bankruptcy (in January 2008), Mervyn's entered into a nonresidential real property lease with a landlord (the "Lease"), and agreed to (among other things) construct, open and operate a Mervyn's department store in Southern California.

Among its many provisions, the Lease also required the Debtors to indemnify the landlord for a multitude of claims, including mechanics' liens. Construction of the store was never completed, and multiple mechanics' liens were recorded against the real property after the Debtors' bankruptcy filings because the Debtors failed to pay the general contractor (and others) for works of improvement. The general contractor also sued the landlord to foreclose the mechanics' liens. The Debtors ultimately rejected the Lease, but the landlord expended several million dollars to settle the mechanics' lien claims and the attendant litigation.

The Landlord subsequently moved in the bankruptcy case to obtain administrative priority treatment of its indemnity claims under § 365(d)(3) of the Bankruptcy Code[1] and thus recover 100% of the mechanics' lien settlement payments from the Debtors. Finding that the Debtors' indemnity obligations arose post-petition and prior to the rejection of the Lease, the Bankruptcy Court sided with the landlord, and required the Debtors to fully reimburse the landlord.[2]

In seeking administrative priority for its claims arising from the Debtors' indemnity obligations, the landlord relied upon the Third Circuit's opinion in *Centerpoint Properties v. Montgomery Ward Holding Corp.* (*In re Montgomery Ward Holding Corp.*).[3] *Montgomery Ward* held that § 365(d)(3) of the Bankruptcy Code requires a debtor under a nonresidential real property lease to timely perform all obligations arising after an order for relief is entered, but before the lease is rejected—even where the landlord's liability arose *before* the order for relief.

In *Montgomery Ward*, the debtor was required to pay real property taxes invoiced by the landlord post-petition, even though they related to pre-petition periods, because the debtor's obligation to pay the taxes arose post-petition.[4] In *Mervyn's Holdings*, rather than real property taxes, the Debtors became obligated to indemnify the landlord when several mechanics' liens were recorded and the landlord was sued by the mechanics' lien claimants—all of which occurred after the Debtors filed their voluntary petitions and before the Lease was rejected.

The *Montgomery Ward* court noted that it is ultimately the terms of the lease that determine the Debtors' obligations and when they arose.[5] In *Mervyn's Holdings*, the Lease contained expansive indemnity language:

> Tenant shall indemnify, defend and save Landlord and any agent, beneficiary, contractor, manager, member, director, employee, lessor, mortgagee, officer, parent, partner, shareholder and trustee of Landlord (collectively the "Landlord Indemnified Parties," and each a "Landlord Indemnified Party") harmless from and against any and all liabilities, suits, obligations, fines, damages, penalties, claims, costs, charges and expenses, including, without limitation, reasonable engineers, architects' and attorneys' fees, court costs and disbursements ("Losses"), which may be imposed upon or incurred by or asserted against Landlord or any Landlord Indemnified Party by reason of any of the following occurring prior to, during or after (but if after, then attributable to a period of time falling prior to or within) the Term:
>
> (ii) any act or failure to act on the part of Tenant or any of its officers, agents, employees or licensees;
>
> (v) any lien or claim which may be alleged to have arisen against or on the Premises from work being performed by Tenant (or anyone acting by, through, under or on behalf of Tenant), or any lien or claim which may be alleged to have arisen out of work performed under this Lease by Tenant (or anyone acting by, through, under or on behalf of Tenant) and created or permitted to be created by Tenant against any assets of Landlord under any law for work being performed by Tenant (or anyone acting by, through, under or on behalf of Tenant), or any liability which may be asserted against Landlord with respect thereto;
>
> (vi) any failure on the part of Tenant to keep, observe and perform any of the terms, covenants, agreements, provisions, conditions or limitations contained in any subleases affecting the Premises on Tenant's part to be kept, observed or performed;
>
> (viii) any Default by Tenant.

The landlord relied upon *Montgomery Ward* and argued that the Debtors' indemnity obligations under the Lease were triggered either in September 2008 (when the mechanics' liens were recorded) or October 2008 (when the landlord was sued by the general contractor), and thus they arose post-petition and pre-rejection. As such, the landlord argued it was entitled to recover dollar-for-dollar what it paid to settle all of the claims arising from the mechanics' liens.

In response, the Debtors argued (among other things) that the landlord's claims were mere general unsecured claims because the indemnity obligations arose when the Lease was executed (pre-petition). In support of that argument, the Debtors relied upon several cases involving executory contracts with indemnification obligations. Alternatively, the Debtors argued that the indemnity obligations related only to the pre-petition construction work.

Thus, if the landlord had any claims at all, the Debtors argued they could only be general unsecured claims, and only payable on a pro rata basis with all other unsecured creditors.

The *Mervyn's Holdings* court found the cases relied upon by the Debtors to be unpersuasive because none involved a lease of nonresidential real property in a shopping center. More importantly though, the *Mervyn's Holdings* court held that while the conduct giving rise to the indemnity obligation occurred pre-petition, the Debtors' obligation to indemnify the landlord arose when the mechanics' liens were recorded and the general contractor sued the landlord to foreclose the mechanics' liens. In response to the Debtors' suggestion that the landlord had no claim against the Debtors until the landlord settled the claims with the general contractor, the *Mervyn's Holdings* court relied upon *Montgomery Ward* and pointed out the difference between a claim and an obligation:

> In the context of section 365(d)(3), the relevant time is when an "obligation" arises, which is different from when a "claim" arises. The Third U.S. Circuit Court of Appeals distinguished a "claim," which is an "unmatured right to payment," from an "obligation," which is "something one is legally required to perform under the terms of the lease."[6]

Lessons for Landlords

For landlords, *Mervyn's Holdings* has not found (and most likely will not find) acceptance in proration jurisdictions. However, given the right indemnity language in its nonresidential real property lease, and a debtor filing its bankruptcy case in a billing date jurisdiction, the *Mervyn's Holdings* case provides a landlord with a powerful tool to minimize its losses associated with mechanics' liens, and to maximize its recovery on a debtor's indemnification obligation.

***Brian D. Huben** is a Partner in the Los Angeles, CA, office of Katten Muchin Rosenman LLP. His practice focuses on the representation of shopping center owners, developers and managers as creditors in retail tenant bankruptcies, and on litigation in state and federal courts.

[1] The relevant portion of § 365(d)(3) states: "The trustee shall timely perform all the obligations of the debtor, except those specified in section 365(b)(2), arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title."

[2] *WM Inland Adjacent, LLC v. Mervyn's, LLC* (*In re Mervyn's Holdings, LLC*), Adv. No. 09-50920 (KG), 2013 WL 85169 (Bankr. D. Del. Jan. 8, 2013).

[3] 268 F.3d 205 (3rd Cir. 2001).

[4] The *Montgomery Ward* case is generally recognized as the leading case describing the "billing date" rule, which is followed in the Third Circuit (among others). On the other hand, the "proration (or accrual)" rule utilized in several other jurisdictions generally requires a debtor to only timely perform obligations as they accrue each day from entry of the order for relief until the nonresidential real property lease is rejected.

[5] *Montgomery Ward*, 268 F.3d at 209–210.

[6] *WM Inland Adjacent, LLC v. Mervyn's, LLC* (*In re Mervyn's Holdings, LLC*), Adv. No. 09-50920 (KG), 2013 WL 85169, at *6 (Bankr. D. Del. Jan. 8, 2013.

Cashing in on ADA Noncompliance: What Store Owners Need to Be Aware of Regarding *The Americans With Disability Act*'s ATM Standards

*George J. Kroculick**
Duane Morris LLP
Philadelphia, PA

Since the March 2012 effective date of the new *Americans With Disabilities Act* ("ADA") standards regulating automated teller machines ("ATMs"), it is estimated that plaintiffs have filed over 100 class-action lawsuits in federal district courts across the country. The plaintiffs in these actions claim that almost half of the nation's 400,000 ATMs are inaccessible to individuals with disabilities; consequently, these individuals allege that they have been discriminated against. The United States Census Bureau estimates that almost 19 percent of the adult, non-incarcerated population, or approximately 54 million people, suffer from some form of disability. Because the new ADA regulations cover all ATMs and because of the extent of the United States population who suffer from disabilities, a store owner who has installed an ATM on the store's premises may face an increased litigation risk if the ATM is noncompliant with the new regulations.

On July 26, 1990, then President George H.W. Bush signed into law the ADA, 42 U.S.C. § 12101 *et seq*., which is designed as a comprehensive civil rights law aimed at prohibiting discrimination based on disability. Title III of the ADA protects individuals with disabilities from discrimination in places of public accommodation and provides that places of public accommodation must be readily accessible to and usable by individuals with disabilities. In addition to other forms of relief, Title III encourages private lawsuits to enforce the provisions of Title III by allowing a successful plaintiff to recover attorney fees and costs, which could be a significant amount.

In 1991, after the enactment of the ADA, the Department of Justice ("DOJ") issued rules governing the implementation of Title III (the "1991 Accessibility Guidelines"), which provided a minimum baseline to ensure that places of public accommodation were accessible to individuals with disabilities. Almost immediately after publication of these guidelines, the DOJ began to revise them. On July 23, 2004, the DOJ published revisions to the 1991 Accessibility Guidelines, known as the "2004 Revisions." The DOJ officially adopted the 2004 Revisions in 2010 (the "2010 ADA Standards").

2010 ADA Standards

Chapter 7 of the 2010 ADA Standards includes many of the salient requirements for ATMs, including:

- *Speech-enabled ATMs.* The operating instructions and orientation, visible transaction prompts, user input verification, error messages and all displayed information for full use shall be accessible to and independently usable by individuals with vision impairments. The ATM shall deliver speech through a mechanism that is readily available to all users, including but not limited to, an industry standard connector or a telephone handset. In addition, speech shall be recorded or digitized human or synthesized.
- *Tactilely discernible input controls.* The 2010 ADA Standards mandate that at least one tactilely discernible input control shall be provided for each function. Where provided, key surfaces not on active areas of display screens shall be raised above surrounding surfaces. Where membrane keys are the only method of input, each shall be tactilely distinct from the other keys.
- *Height and display requirements.* The 2010 ADA Standards require that the display screen on an ATM shall be visible from a point located 40 inches above the center of the clear floor space in front of the machine. Characters displayed on the ATM's screen shall be in a sans serif font and shall be 3/16 of an inch high. Moreover, the characters displayed on the ATM shall contrast with the screen's background. The contrast may be either light characters on a dark background or dark characters on a light background.
- *Braille instructions*. An ATM must offer Braille instructions for initiating the speech mode.

With certain exceptions, all places of public accommodation must comply with the 2010 ADA Guidelines. However, if a place of public accommodation provides its customers with more than one ATM, the 2010 ADA Standards do not require each ATM to be compliant. Rather, at least one ATM at each location must comply.

The 2010 ADA Guidelines included a grace period until March 15, 2012, to comply with the new criteria. Failure to comply with the new requirements by this deadline could expose a store owner to litigation risk. The ADA includes multiple avenues to pursue claims of discrimination against stores operating noncompliant ATMs. First, the DOJ is empowered to conduct compliance audits. If a compliance audit detects a violation, the DOJ may impose civil fines of up to $55,000 for the first offense and up to $110,000 for subsequent offenses. The DOJ can audit an institution of any size. It is expected that the DOJ will focus its enforcement efforts on larger institutions. In an era of heightened compliance scrutiny, even a single complaint of discrimination filed with the DOJ may be enough to trigger a compliance audit.

Moreover, the ADA authorizes both civil and private lawsuits, fines and penalties. In the current group of filed class-action lawsuits, the plaintiffs generally have sought both injunctive relief and declaratory relief. The plaintiffs have asked the federal district court to grant an injunction directing the named defendant to take all necessary steps to become fully compliant with the 2010 ADA Standards. Additionally, the plaintiffs have requested the court to issue a declaration stating that the defendants have failed to comply with the 2010 ADA Standards. Finally, plaintiffs have included claims of discrimination based on state-law civil rights statutes. Many times, these statutes authorize courts to award damages for violations of civil liberties or reimbursement of attorney fees and litigation costs.

Limited Exemption and Grace Period

The primary exception to the regulations and defense available to ATM owners who have been accused of discrimination against individuals with disabilities by owning or operating noncompliant ATMs is to argue that implementation of such requirements would result in an "undue burden." The burden is on the ATM owner to seek the exemption and prove the burden. Undue burden has been defined to mean either significantly difficult or expensive. However, a precise standard of what constitutes significantly difficult or expensive has not been established. Rather, courts have used a case-by-case analysis to determine whether implementation of the 2010 ADA Standards constitutes an undue burden. Some factors that a court may consider when determining whether compliance would result in an undue burden include the nature and cost of the action required and the store's overall resources. This is a very subjective standard, however. It is also important to remember that a defendant who successfully asserts an undue burden defense is not excused from compliance with the 2010 ADA Standards. Rather, a successfully asserted undue burden defense only allows a store owner to delay implementation of the Standards. In fact, presenting a court with a strategic plan and timeline of when the ATMs will become ADA-compliant is a factor that a court would consider in its evaluation of the undue burden defense.

The 2010 ADA Standards include a safe-harbor defense to certain claims; however, the communication requirements included in the ATM regulations do not qualify for this defense. The safe-harbor exception provides that for ATMs built in compliance with the 1991 Accessibility Guidelines, the 1991 Accessibility Guideline compliant ATMs would not have to meet the 2010 ADA Standards by the implementation deadline of March 15, 2012. The safe- harbor provision applies to the structural features of an ATM, including the height of operable parts and bins, if provided, for envelopes, waste paper or other items. But, this safe-harbor exception does not apply to the communication standards because the DOJ has classified these elements as auxiliary aids and services. Because auxiliary aids and services do not constitute structural elements, the DOJ finds that, as a result, the safe-harbor exception does not apply.

Finally, it is not a defense to argue that because a store owner leases an ATM, he or she cannot be held liable. If the ATM is located in a store, the store owner certainly would be named as a defendant in an ATM discrimination suit. If a store owner leases an ATM, he or she should contact the ATM owner to make sure that the ATM is ADA-compliant.

Practical Steps to Ensure Compliance

Even though many lawsuits have been filed alleging discrimination, there are several steps that a store owner who owns or leases an ATM on the store premises can take to reduce his or her exposure to litigation:

- *Have an ADA-trained expert inspect and evaluate the ATM*. While it may not be an inexpensive option to have an inspector who is trained in ADA accessibility standards, the cost of hiring such an expert would certainly be significantly cheaper than be named as a defendant in a federal class-action lawsuit.
- *Do not assume that newly purchased ATMs are ADA-compliant*. Communicate with the ATM vendor to ensure that any newly purchased ATM is ADA- compliant.
- *If you are having difficulty implementing the 2010 ADA Standards, contact an attorney.* An attorney can assist in both evaluating how courts have applied the undue burden defense and applying the facts of your situation to how the law has developed. An attorney can also assist in preparing a budget, a strategic plan for how the store will become ADA-compliant and a timeline implementing the strategic plan.
- *Establish proper training procedures.* Developing a protocol to allow staff to appropriately and quickly respond if a customer complains about a lack of accessibility will help in two ways. First, a training protocol will assist in demonstrating that the store is ADA-compliant. Second, effective and prompt customer service may both satisfy the customer and prevent a lawsuit before it gets started.

While the 2010 ADA Standards have led to an increased concern over ATM compliance, it would be also be a good opportunity to review your store's overall compliance with the ADA. The ADA has significant guidance and regulations over places of public accommodation. Prudent practice dictates periodic review to ensure continued compliance with the most recent versions of the requirements.

Since March 15, 2012, the ADA has required all ATMs to be compliant with the 2010 ADA Standards. After the effective date of the 2010 ADA Standards, individuals with disabilities have begun filing class-action lawsuits to enforce the provisions of these guidelines. While there is no way to completely insulate oneself from being named as a defendant in a lawsuit, there are several concrete steps that a store owner can take to minimize his or her risk of exposure. Inspecting all ATMs in the

premises to ensure compliance and consulting with an attorney to develop an implementation plan and schedule if the ATMs are not in compliance are concrete steps that a store owner can take to reduce his or her exposure to discrimination claims based on noncompliance with the 2010 ADA Standards.

***George J. Kroculick** practices in the area of real estate law with a focus on eminent domain and highway access management and control, land use and land use litigation, relocation assistance, tax appeal matters, and general commercial litigation. Mr. Kroculick has represented clients before local and county land use boards and has worked on lease litigation matters as well as title disputes.

Retail Cybersecurity: Demystifying PCI Compliance

*Andy Roth**
Dentons US LLP
New York, NY

It seems that almost every day a major retailer is being vilified in the news for suffering a data breach. Although the financial costs associated with these incidents can be substantial, the legal and brand injury can be incredibly damaging.

The rapid development of retail technology comes with very real risk. As retailers move to engage customers in new interactive channels, such as online and through apps, tremendous amounts of transactional and behavioral data are generated. The advent of "big data" has accelerated this movement; increasingly, companies view data as a core asset and have built systems to obtain and store it. These data assets are extremely attractive to hackers and criminals who will attack and exploit vulnerabilities in cybersecurity defenses. For them, this data is currency—particularly stolen payment card details. A robust black market exists for trading this information.

In recognition of this emerging security risk, the payment card networks joined together in December 2004 to implement the Payment Card Industry ("PCI") Data Security Standard ("the Standard"), which establishes baseline requirements for merchant and service provider data security standards. While there is a sliding scale for compliance certification, the substantive provisions of the standards apply equally to all companies in the payment chain.

PCI requires many of the same security controls that can be found in other well- established industry security standards such as ISO/IEC 270001. However, PCI has tailored these requirements to meet the specific risks inherent to payments.

How to Ensure Your Company Is PCI-Compliant

Every company seeking to demonstrate PCI compliance must fill out a Self-Assessment Questionnaire ("SAQ"). There are five different SAQ forms, each one of which is tailored for a type of merchant. For example, big-box retailers fill out a form that is materially different from the one for e-commerce merchants.

The SAQ itself consists of a long list of "yes" or "no" questions. Failure to answer all questions or answering one or more questions with a "no" will automatically result in a certification of Non-Compliance with the PCI Data Security Standard. The core areas covered in the SAQ are:

- Building and maintaining secure networks (e.g., firewall, encryption)
- Maintaining a vulnerability management program (e.g., antivirus, security updates)
- Implementing strong access controls (e.g., restricting physical and system access)
- Regularly monitoring and testing networks (e.g., monitoring access, testing systems and processes)
- Maintaining an information security policy (e.g., clearly laying out rules for all personnel)

In addition to answering "yes" to all questions on the SAQ, companies must have a PCI Approved Scanning Vendor ("ASV") perform a comprehensive vulnerability scan validating that the company meets the PCI requirements. Once the scan is complete, the company must sign an Attestation of Compliance and submit it, along with the SAQ and the scan results, to the entity requiring proof of PCI compliance (for merchants) or to the payment brand or other requester (for service providers).

Your Vendors May Also Need to Be PCI-Compliant

Any vendor handling a company's payment information must also comply with PCI standards. Often, companies with long-standing vendor relationships find that their vendors signed agreements before PCI standards became commonplace, and many of the vendors have failed to stay current with requirements. The same risk exists for other privacy and security contractual requirements, such as breach notification, which have become bedrock requirements in current agreements but may not have been included in agreements entered into years ago.

Vendors pose very real risks to the privacy and security of retailers' payment card information. Many of the highest profile breaches have occurred at the vendor level.

Yet, retailers are at risk to suffer the most damage financially and to their reputations. In light of this, every retail merchant should ensure that it has a strong Vendor Security Management program, including strict contractual requirements around PCI compliance and other important standards. This can help substantially reduce the risk that these relationships pose.

Legal Risks of PCI Noncompliance

Each payment card network has its own compliance program for PCI, including a set of rules for disciplining and penalizing companies that fail to meet the Standard. For example, American Express follows a Data Security Operating Procedure that addresses situations that enable a data breach—e.g., noncompliance. In addition to posing legal issues with the payment networks, noncompliance may also attract the attention of federal and state regulatory authorities, such as the Federal Trade

Commission and the State Attorneys General. While these agencies do not have the power to enforce the PCI Standard as such, they can and will scrutinize companies for failing to meet the generally accepted security standards contained in PCI, such as having an adequate firewall and strong access controls.

Mitigating Risk

Cybersecurity is a dynamic space. Therefore, the nature of threats that retailers face from thieves seeking to steal payment card information evolves on a daily basis. Do not wait until you are aware of a data breach to begin hardening your defenses. While PCI is a strong framework, compliance with PCI is by no means a silver bullet.

Sustainable governance is the foundation of strong risk management, and PCI works best when it is part of a program. So, in addition to building these requirements into the roles and responsibilities of each retailer's compliance and control teams, make strong privacy and security practices the responsibility of every employee, at every level.

Conclusion

Companies will most likely continue to make headlines for large-scale breaches of personal information, including payment card information. Ensuring PCI compliance by committing resources to building a security program, raising the bar on expectations for all those that manage each retailer's data (from vendors down through employees), and regularly monitoring and improving the performance of your security program are the keys to protecting your customers and, in turn, your brand.

***Andy Roth** is a Partner in the New York office of Dentons US LLP and Co-Chair of the firm's Global Privacy and Security Practice.

Supreme Court Builds on Land Use Cases

*J. Yost Conner, Jr.**
Patton Boggs LLP
Washington, DC

In *Koontz v. St. Johns River Water Management District*,[1] the United States Supreme Court once again announced a decision with positive results for owners and developers of real property. *Koontz* is a logical extension of the Court's decisions in *Nollan v. California Coastal Commission*[2] and *Dolan v. City of Tigard*.[3] Each of these cases had already delved into the tension between takings jurisprudence and the state's proper exercise of its police power; in addition, the Court explored the unconstitutional conditions doctrine. *Koontz* develops that scrutiny and adds an important new component to the constitutional analysis. To recognize that logic, a brief revisit to *Nollan* and *Dolan* is in order.

Prior to *Nollan*, many assumed that land use decisions fell squarely under the state's police power. Courts had explored conditional denial of rights in other contexts, but in the land use setting, exactions in exchange for development permits were commonplace. The operating proposition was that land use regulation that substantially advanced a legitimate state interest was not a taking.[4] This was somewhat intuitive with respect to broadly applied zoning ordinances, but it also included exactions and proffer negotiations where individual permits were made conditional on those exactions and proffers. In the absence of a taking, governments could sometimes exact substantial concessions from landowners as conditions of development permits.

Nollan

Nollan changed that calculus. It established the principal that the exactions that governments may demand must have an "essential nexus" to the development that the landowner seeks to undertake. The landowners in *Nollan* had exercised an option to purchase a bungalow adjacent to the beach in Ventura County, CA. The lot on which the building sat, extended to the mean high tide line of the Pacific Ocean. The portion of the beach between the mean high tide line and the water was public. There were public beaches to the north and to the south of the Nollans' lot, though neither was immediately adjacent.

When the Nollans sought permits to raze the building and replace it with a larger home, the California Coastal Commission seized the opportunity to demand an easement across the Nollans' private portion of the beach for public use. Together with other easements the Commission was seeking—and in several cases had already obtained—the Commission sought to create a public corridor between the two public beaches. The Commission granted the development permit, only on the condition that the Nollans must grant the easement on their private beach. Following several procedural steps, the Commission made a factual finding that the Nollans' new home would create a visual blockage between the public road and the beach—a condition that the Commission termed a psychological barrier.

Writing for a sharply divided court, Justice Scalia began by noting the tension between takings and land use management law. He observed that, had the Commission simply sought an easement across the Nollans' private beach without the house ever being at issue, there would have been a taking and the government would have been required to pay compensation.

Mocking any contrary analysis, Justice Scalia said it was obvious the unconstitutional conditions doctrine required that this result extend to other methods by which the government might take property rights; he turned to analysis of the Commission's stated reasons for the easement. The Justice concluded that even if the Commission's concern over visual and psychological barriers were a valid reason for an exaction, there was not a nexus between that concern and the easement the Commission actually sought from the Nollans. An easement connecting the two public beaches would not create a view corridor between the road and the water, nor would it mitigate concerns over a psychological barrier. Therefore, the Commission's easement demand was an unconstitutional condition, and the Court struck it down.

Thus was born the "essential nexus" standard for exactions; but since the exactions in question in *Nollan* did not have even an essential nexus to the construction the Nollans proposed, the Court did not have the opportunity to explore the degree of connection necessary between proposed permits and related exactions. The development of that standard fell to *Dolan*.

Dolan

The landowner in *Dolan* owned a parcel in downtown Tigard, OR, where she operated a plumbing and electrical business. The business had a gravel parking area. At the rear of the lot, there was a stream with a floodplain. Dolan sought to double the size of the building housing her business, and to enlarge and pave the parking area. As one condition to approval of her permits, the City demanded that Dolan dedicate the entirety of her land within the floodplain for drainage improvements. Had the City's demands stopped there, Dolan might never have challenged the City's authority. The doubling of the size of the business as well as the enlargement and paving of the parking area unquestionably increased the impervious area of the lot and added incrementally to the flow of the creek; therefore, an essential nexus appeared to have existed.

However, the City's demands did not stop with the floodplain. The City reasoned that enlarging the business was likely to increase automobile traffic; estimating that the effect on automobile traffic might be mitigated by encouraging customers to

arrive by bike rather than by car the City demanded, as an additional condition of Dolan's permit, that she dedicate a 15-ft. strip along the entire upland side of the flood plain for the construction of a public greenway— including a combined walking and biking trail. The City's intent was to connect that segment to a larger greenway that the City was already developing.

Dolan believed that the demand for the additional land constituted an uncompensated taking and was an unconstitutional condition of her redevelopment permit, so she embarked on the litigation that ended up before the Supreme Court. Echoing Justice Scalia's observation in *Nollan*, Chief Justice Rehnquist observed that, had the City demanded that Dolan dedicate a strip of her land for public use in the absence of her redevelopment permit application, there would unquestionably have been a taking. Engaging in a *Nollan* analysis, the Chief Justice first concluded that there was an essential nexus between the project and the permit conditions because the project could incrementally increase both water runoff and automobile traffic.

Thus, the bare *Nollan* conditions were satisfied. In *Dolan*, however, the Court had the opportunity it did not have in *Nollan*—the opportunity to examine the degree to which the exactions bore a relationship to the proposed project.

The Chief Justice reviewed the approaches of several state courts to similar situations and, in Goldilocks fashion, decided that (i) a generalized statement as to the necessity for the exactions as a result of the proposed project was too lax and (ii) an exacting correspondence between the proposed project and the exactions was too rigid. Even a "reasonable relationship" between the two issues was not just right because it sounded too much like rational basis analysis under the Equal Protection Clause of the Fourteenth Amendment. Writing for another sharply divided Court, the Chief Justice finally settled on a "rough proportionality" test. Exactions must have a rough proportionality to the impacts of the projects giving rise to the exactions.

The Court held that the City's findings were not sufficient to "show the required reasonable relationship"[5] between the project and the demand for dedication of the floodplain. The Court was even more critical of the City's findings with respect to the greenway easement. Since the City had relied only on a generalized assumption that a bike path might reduce automobile traffic to the business and that Dolan had not engaged in specific analysis or findings, the Court concluded that there was no rough proportionality between the proposed project and an easement for a bike path.

Koontz

The procedural posture in *Koontz* was different. Here, rather than issue a conditional permit, as had the jurisdictions in *Nollan* and *Dolan*, the St. Johns River Water Management District simply denied the landowner a development permit because the landowner signaled he was unwilling to accede to the government's demands. Inexplicably, the Florida Supreme Court saw a meaningful distinction between granting a permit with conditions and denying a permit when a landowner signals an unwillingness to undertake the government's demands.

The landowner in *Koontz* owned a parcel of nearly 15 acres in a commercially desirable location east of Orlando, FL. A power line divided the property into two sections—a southern section that was largely unbuildable due to the presence of wetlands and a northern section that was mainly dry and buildable but for some drainage ditches and road ruts that sometimes held standing water. During the more than two decades in which the landowner owned the property before seeking to develop it, the State of Florida adopted statutes regulating surface water and requiring mitigation for construction that affected wetlands. The landowner proposed the development of a 3.7-acre site in the northern section. The proposed development required fill on the site to bring it to buildable condition, and the fill was to have been graded down to the power line. There was to have been a dry pond for stormwater management. Since this work would affect both surface waters and wetlands, Koontz filed for the appropriate surface water and wetlands management permits. As part of his application, he offered to grant a conservation easement on 11 acres in the southern section.

However, the government wanted more. It refused the permits unless Koontz agreed to satisfy one of three options:

(i) Reduce the development to a single acre, and grant a conservation easement over the entirety of the balance of his land,
(ii) Proceed as planned, and pay for significant drainage improvements on land the District owned elsewhere, or
(iii) Propose and pay for something equivalent.

In addition to reducing the size of the development, the first option would also have increased cost—requiring underground stormwater retention facilities and retaining walls in lieu of a gradual slope to the power line. The second and third options would have required Koontz to spend his own money for improvements elsewhere. Koontz balked at these demands and filed suit.

After several *mesne* steps, the case arrived at the Supreme Court presenting two questions:

(i) Was it relevant that the District denied the permits outright rather than issuing permits with conditions?
(ii) When a government demands an exaction in connection with a development, is there a distinction between a demand for an interest in the real property and a demand for the landowner's money?

The Court was unanimous in answering the first question; the government may not evade the *Nollan* and *Dolan* standards by denying a permit rather than issuing a conditional permit.[6] Writing for the majority, Justice Alito reiterated that extortionate demands related to land use permits "impermissibly burden the right not to have property taken without just compensation."[7] The right was certainly as potentially burdened in *Koontz* as it was in *Nollan* and *Dolan*. The Court remanded for further consideration of the case applying the *Nollan* and *Dolan* standards.

The Court then addressed the second question: The important new ground in *Koontz* is the Court's consideration of monetary exactions in land use cases. The District, in reliance on an earlier case not involving land use, argued that demands for money do not constitute takings. The Court, however, disagreed. It noted that if governments could demand unreasonable cash payments in lieu of taking real property, they could too easily evade *Nollan* and *Dolan*. In cases where a government demands cash (or the spending of cash) as a condition to approval of a land use permit, there is a direct connection between the real property and the cash, and the exaction is subject to the *Nollan* and *Dolan* analyses.

In so finding, the Court rejected the dissent's concerns that it would be too difficult to distinguish between takings, on the one hand, and fees or taxes on the other. With respect to fees, the Court noted that numerous state courts had already examined fees under the *Nollan* and *Dolan* standards without difficulty, and refused to take the inquiry further. With respect to taxes, the Court observed that the District did not even have taxing authority, so the District's demand for funds to improve its lots could not be characterized as taxes. The Court declined to examine where the line between takings and taxes might be drawn in other jurisdictions, leaving room for further development in future cases.

***J. Yost Conner, Jr.,** a Partner in Patton Boggs's Washington, DC, office, merges practical experience in real estate development, design and construction with legal analysis to assist developers, owners and tenants in recognizing, avoiding and resolving problems in commercial real estate transactions and construction projects. Mr. Conner represents clients in complex, multi-stage and multi-party projects throughout the United States and in other areas of the world.

[1] 570 U.S. ___ (No. 11-147, October Term, 2013).

[2] 483 U.S. 825 (1987).

[3] 512 U.S. 374 (1994).

[4] *Agins v. City of Tiburon*, 447 U.S. 255, 260 (1980).

[5] *Dolan v. City of Tigard, supra.*

[6] Koontz, 570 U.S. at ___ (Kagan, J., dissenting), agreeing with the majority that there is no substantive difference under *Nollan* and *Dolan* between denying a permit for want of exactions and conditioning a permit on the same exactions.

[7] *Id*. at ___ (majority opinion).

Negligence for Misplacing Confidential Data—When the Economic Loss Doctrine May Not Apply

*Gary S. Kessler**
*Philip G. McNicholas***
Kessler Collins PC
Dallas, TX

Introduction

Before the age of the Internet and social media, there was something called "privacy." Most individuals kept their lives relatively secret; very little personal information was revealed to the outside world. But as time has passed and the web of social media has grown, people generally feel more and more comfortable disclosing every intimate detail about themselves to whomever is viewing their Facebook wall, Twitter feed or other social media outlet.

As part and parcel with this increased comfort with self-exposure, individuals have also become more comfortable with disclosing other private information formerly held as sacred. People everywhere now make online purchases by submitting credit card information, all without blinking an eye. They also provide their names, addresses, birthdates and even Social Security numbers online for a variety of reasons. While the vast majority of websites requesting such information provides secure portals, personal data cannot always be safeguarded with absolute certainty. A hacker might steal someone's credit card information, charge the card one or many times, and disappear with stolen goods never to be found. And acquiring such information no longer requires physically breaking into a building, safe or other protected location as it did before the Internet. Now, access to confidential information simply requires cyber hacking, which is much quicker, easier and less risky.

The monetary loss caused by such intrusions can be material. The SEC has issued regulations dictating the disclosure that is required by public companies as to the materiality of the risk to the companies from such an intrusion. Companies now have to evaluate the financial exposure that could result from a data breach.

In the past, many commercial liability and D&O (Directors and Officers) liability insurance policies (protects directors and officers at corporations against lawsuits by shareholders, employees or creditors) have afforded coverage for data breaches without the necessity of an express endorsement or additional premium. However, both with a growing threat and a significant loss history, many insurers are now excluding such coverage from traditional policies and requiring specialty policies that are being underwritten separately based on the insured's risk of loss.

When it comes to the types of loss, identity theft creates a laundry list of inconveniences for the individual(s) whose information was revealed—including their need to close and re-open bank accounts, monitor credit reports and have a constant concern of future recurrences. It has been the focus of much litigation, including consumer class actions. Moreover, the class of potential claimants has now been expanded.

Historically, liability for negligence was often limited to occasions in which an injured party suffers physical injury; however, the Fifth Circuit's recent decision in *Lone Star National Bank, N.A. v. Heartland Payments Systems, Inc.*[1] shows that state courts have recognized exceptions to this rule and will likely continue to add exceptions. As more exceptions are added, businesses and individuals in possession of confidential information may face significant financial backlash if such information is negligently disclosed.

This article will first discuss the origin and rationale for the rule requiring physical injury for negligence, which is also known as the "economic loss doctrine." It will then list a few exceptions to that rule, which have been recognized by various states. It will analyze the 2013 *Lone Star National Bank, N.A.,* decision and its interpretation of New Jersey law's version of the economic loss doctrine. Finally, the article will discuss the potential impact of this ruling on future liability for entities that misplace confidential information.

Background on the Economic Loss Doctrine

The economic loss doctrine (the "doctrine") addresses the types of damages that can be recovered on negligence and other tort claims as compared to contract claims. In some cases, the doctrine prohibits any recovery of "pure economic loss" for negligence and other torts when those losses are the subject matter of a contract. (Pure economic loss includes only direct economic losses and/or consequential economic losses.)

In other words, if there is no personal injury or property damage, recovery may not be permitted under tort theories of recovery. Also, for losses that are the subject matter of a contract, the doctrine has been applied to preclude tort claims between parties who are not in privity.

Rationale Behind the Rule

The rationale behind the rule is that contract and tort causes of action should remain discrete. Tort claims generally provide a means for reimbursement for physical injury or damage to property. Contract claims are the appropriate venue for recouping financial injury. The rule attempts to maintain this bright-line distinction between tort and contract bases of recovery.

The doctrine was developed through the court system and has been accepted in one form or another by most jurisdictions in the United States.

Exceptions to the Traditional Doctrine

Although there is a traditional Economic Loss Doctrine, not all states have identically conformed to it. While many states remain steadfast to the traditional rule, others (described below) have created exceptions, thus departing from the traditional rule.

J'Aire Corp. v. Gregory[2]

In 1979, in *J'Aire Corp. v. Gregory*, the Supreme Court of California was the first state court to deviate, substantially, from the customary Economic Loss Doctrine: The court allowed the existence of a negligence cause of action for pure economic loss where the plaintiff showed a special relationship between himself and the defendant. According to the *J'Aire Corp.* ruling, the existence of a special relationship depends on six factors:

1. Extent to which the transaction was intended to affect the plaintiff
2. Foreseeability of harm to the plaintiff
3. Degree of certainty that the plaintiff suffered injury
4. Proximity of connection between the conduct and the injury
5. Moral blame attached to the defendant's conduct and
6. Policy of preventing future similar harm

Additional states have recognized some version of this "special relationship" exception to the doctrine, including Idaho, New Hampshire and West Virginia.

Some other exceptions to the doctrine, which have been recognized by various states, include: exclusions for the specific tort committed (e.g., fraud, fraudulent inducement, professional negligence); situations in which tort duties arise separate and apart from contractual duties; sudden disastrous events; and lack of privity of contract with the tortfeasor.

Lone Star National Bank

When a person uses a bank-issued credit card or debit card, his or her personal information is transmitted through a chain of institutions. First, the information is provided to the merchant. Second, the merchant sends the customer's information to the merchant's bank ("Acquirer"). Third, the Acquirer Bank sends that information to a credit card processor. Fourth, the processor passes the information along to the bank that issued the card to the customer ("Issuer Bank"). Fifth, the Issuer Bank either approves or denies the use of the card and transmits this response back to the merchant using the same chain.

In *Lone Star National Bank, N.A.*, a credit card processor's data system was hacked and credit card information was stolen and used. Because of this breach, a number of issuer banks suffered significant losses, as they were obligated to reimburse their cardholders for unauthorized charges. The issuer banks had no contract with the credit card processor ("Heartland"), as credit card processors are selected by and contract with acquirer banks. The issuer banks asserted various claims against Heartland, including negligence and contract claims as third-party beneficiaries of Heartland's contracts with other entities.

The district court dismissed all of the issuer banks' claims against Heartland. Specifically, as to negligence, the court held that under either Texas law or New Jersey law (a disputed issue in the lawsuit), the economic loss doctrine would bar the issuer banks' claims.

On appeal, the Fifth Circuit agreed that if Texas law applies, the issuer banks' claims would be barred by the economic loss doctrine. However, the Fifth Circuit reversed, holding that if New Jersey law applies, the economic loss doctrine would not bar the issuer banks' negligence claim.

People Express Airlines, Inc.[3]

Citing *People Express Airlines, Inc.*, the court held that "under New Jersey law, the economic loss doctrine does not bar tort recovery where the defendant causes an identifiable class of plaintiffs to which it owes a duty of care to suffer economic loss that does not result in boundless liability."

Here, the issuer banks constitute an "identifiable class of plaintiffs," since Heartland could reasonably foresee that these entities would suffer economic losses if Heartland acted negligently. Also, Heartland would not be exposed to "boundless liability" since the number of injured entities is limited and their losses are reasonable. Finally, if the issuer banks cannot bring a claim for negligence against Heartland, they may be left with no remedy for recovery since it was unclear whether Heartland's contracts with other entities provided the issuer banks with any protection.

Conclusion and Advice

It goes without saying that any entity possessing confidential information must treat that information with the utmost care. Even with the more lax attitudes that individuals now have toward keeping their confidential information private, the repercussions are serious and, based on *Lone Star National Bank, N.A.*, may in fact grow. In the past, an entity that allowed such

information to be leaked may have been liable to the person whose information was stolen. Now, if more state courts follow the Fifth Circuit's lead, an entity may also be liable for the subsequent actions of hackers or other individuals who illicitly acquire and use private data.

Accordingly, if private information must be possessed, all precautions must be taken to secure the confidential information. The added threat of financial exposure for the acts of an identity thief should show that the costs of protecting confidential information are minimal compared to the repercussions for negligent disclosure of such information.

*GARY KESSLER is President of Kessler Collins, is Board Certified in Civil Trial Practice and has been named Texas "Super Lawyer." He has been included in the Best Lawyers in America for more than 15 years. He has tried cases involving insurance, securities, intellectual property and corporate matters, and has argued before the Texas Supreme Court and multiple federal circuit courts.

**PHILIP MCNICHOLAS is an Associate.

[1] No. 12-20648, Sept. 3, 2013 (5th Cir.).

[2] *24 Cal.3d 799 (Cal. 1979).*

[3] *People Express Airlines, Inc. v. Consolidated Rail Corp.*, 495 A.2d 107 (N.J. 1985).

Massachusetts Supreme Judicial Court Limits Common Law Damage Remedies for Landlords after Tenant Default and Lease Termination

*Jean C. Bowe**
*Karen O'Malley***
Gary M. Ronan‡
Goulston & Storrs, P.C.
Boston, MA

Introduction

While all landlords hope that they will not need to exercise remedies against a tenant for a default during the term of their lease, if a default occurs, the availability and enforceability of remedies and the ability to collect rent and/or damages from a defaulting tenant are of critical importance to landlords.

The Massachusetts Supreme Judicial Court, in *275 Washington Street Corp., Trustee v. Hudson River Int'l, LLC*, 465 Mass. 16 (2013), recently rendered a decision of significant importance to landlords and leasing lawyers in Massachusetts, and perhaps elsewhere, with respect to the enforceability of certain damage remedies. The court decided that a landlord seeking to recover post-termination rent due under an indemnification provision in a commercial lease, absent specific language in the lease allowing the landlord to recover damages prior to the end of the lease term, must await the end of the lease term to recover its damages because until that time the amount of the recoverable damages could not be determined with sufficient certainty.

This article examines the court's decision, as well as the implications for leasing lawyers going forward and suggests lease language to help minimize the risk that landlords will find that the remedies they thought they had under a lease are actually unavailable or unenforceable in Massachusetts.

Facts of the Case

In 2006, the landlord and tenant entered into a 12-year commercial lease for dental office space in Boston. One year after the commencement of the lease term, the tenant stopped operating in the premises but continued to pay some rent. By 2008, the tenant stopped paying rent altogether and had removed its equipment from the premises. The landlord then terminated the lease and retook possession of the premises (as it was permitted to do under the lease) and then sought to recover damages as a result of the tenant's default. In 2010, the landlord signed a new 10-year lease for the premises with a replacement tenant but at a lower rent than under the original lease. The lower court awarded damages to the landlord (i) for the rent due from the date of the lease termination until the premises were re-let, (ii) the difference between the original rental rate and the rental rate to be paid by the replacement tenant for the period after the re-letting, (iii) interest and (iv) attorney fees. The tenant appealed.

The lease at issue in *275 Washington Street Corp.* provided that "Tenant shall indemnify Landlord against all loss of rent and other payments which Landlord may incur by reason of such termination [of the lease] during the remainder of the term [of the lease]."[1] The lease did not grant the landlord the option to elect a liquidated damages remedy or other alternative remedy to compensate it for the loss of post-termination rent. Furthermore, the lease did not specify a date by which losses under the indemnity provision could be recovered.

Issues Presented and the Court's Decision

As the court succinctly described, the main issues presented were:

1) "after a breach of a commercial lease by the tenant and termination of the lease by the landlord, does an indemnification clause in the lease, in the absence of specific language so providing, allow the landlord to recover before the end of the lease term the present value of lost future rent once the landlord re-lets the property to another tenant for the duration of the lease?" and
2) "in the absence of a clause in the lease specifically so providing, does our common law allow a landlord to recover contract damages for the present value of lost future rent after the termination of the lease?"[2]

The court answered "no" to both questions, finding first that the common law rule is that a landlord suing under an indemnification provision must await the end of the lease term (in this case 2018) before it may recover its losses because "a substantial degree of uncertainty remains" until that time concerning the amount to be indemnified. For instance, the court noted that the premises may be destroyed in a fire or a replacement tenant may default and vacate the premises before the end of the term of the original tenant's lease. These contingencies, the court found, cannot be eliminated until the end of the term of the lease.

Second, the court found that without the lease specifically providing otherwise, the common law contract remedy of "benefit of the bargain" damages (i.e., the value of the lost future rent that the landlord had bargained for) was not available

under a lease at common law because once the landlord terminates a lease, the tenant's contractual obligation to pay rent ceases. Therefore, the court reasoned, there are no damages under common law contract for a landlord to collect post-termination.

The court explicitly acknowledged, however, that these common law rules apply only where the parties to a lease have not provided for a specifically negotiated provision, such as a provision that identifies when damages under an indemnification provision are due or a provision that requires the tenant to pay post-termination amounts in lieu of rent. In fact, the court noted that landlords are and have been on notice for many years that Massachusetts common law does not afford them the protections that the landlord was asking for in *275 Washington Street Corp.*, and therefore the court was not sympathetic to a landlord who failed to protect itself adequately with language in the lease.

Implications for Commercial Leases and Sample Lease Provisions

Generally, *275 Washington Street Corp.* is a reminder to commercial leasing lawyers in all jurisdictions to be clear in all lease provisions (but particularly when addressing damages recoverable by a landlord in the event of a tenant default), not to rely on general indemnity language or common law as a path to recovery, and to provide for express and acceptable remedies.

To be clear, the court did *not* hold that damages are not recoverable prior to the end of the lease term under indemnity clauses or that benefit of the bargain-type damages are not an enforceable type of remedy in Massachusetts leases.[3] Rather, the court declined to make these types of remedies available to landlords under common law where the lease itself did not specify that such a remedy was available to the landlord in the event of a tenant default. Landlords can (and should) opt out of the common law rules by providing a more specific indemnification or liquidated damages remedy (or remedies) in their leases. The court has put the burden on landlords and leasing lawyers to be sure that landlords' interests are adequately protected in their lease documents and that remedy and damages clauses are clear and explicit. In addition, the court expressly acknowledged that it is often the reasonable expectation of sophisticated landlords and tenants that liquidated damages and payments in lieu of rent will be due post-termination and before the expiration of what would have been the lease term.[4]

Because the court reaffirmed the well-settled rule in Massachusetts that, absent an express obligation created in a lease, a tenant has no obligation to pay rent that accrues after a landlord terminates the lease, even though the termination followed a tenant default, landlords must be clear that post-termination payments or charges in lieu of rent continue to be due from the tenant through what would have been the expiration of the lease term.

A landlord may decide that it is advantageous for it to collect post-termination payments in lieu of rent on an ongoing monthly basis from the former tenant (less any amounts received on account of re-letting). However, most landlords at least want the option to accelerate the amount due for lost future rent and collect a lump sum immediately post-termination, less the rental value of the premises. Therefore, prudent landlords should include acceleration of damages as an alternative remedy in their leases. In addition, a landlord may determine that as a further alternative it prefers to state an exact amount of liquidated damages (e.g., 12 months of rent) due upon lease termination, instead of relying on a calculation of future lost rent and/or rental value of the premises.

While the circumstances of every lease transaction vary in terms of complexity, leverage and the needs of the parties, the following are samples of basic lease language addressing the three concepts noted above:

> ***Sample A:*** *In the event of any termination or repossession, Tenant shall pay to Landlord, on the first day of each month, from the date of termination or repossession through the entire balance of the term, 1/12th of the annual fixed rent, [additional rent, percentage rent] and all other amounts for which Tenant is obligated under the Lease, less the actual net proceeds of any re-letting (after deducting Landlord's reasonable expenses in connection with such re-letting). Alternatively, at the election of Landlord, Tenant shall pay upon demand and at the option of Landlord at any time thereafter, the present value of the amount by which the payments of fixed rent, [additional rent, percentage rent] and all other amounts for which Tenant is obligated for the balance of the term would exceed the fair rental value of the Premises.*
>
> ***Sample B:*** *Tenant covenants and agrees, notwithstanding any termination of this Lease or any entry or re-entry by Landlord, to pay and be liable for on the days originally fixed herein for the payment thereof, amounts equal to the installments of rent and other charges reserve as they would become due if this Lease had not been terminated or if Landlord had not entered or re-entered, and whether the demised premises be re-let or remain vacant, in whole or in part, or for a period less than the remainder of the term; provided, however, in the event the demised premises are re-let by Landlord, Tenant shall be entitled to a credit in the net amount of rent received by Landlord in re-letting, after deduction of all expenses incurred in re-letting the demised premises, and in collecting the rent in connection therewith.*
>
> *As an alternative, at the election of Landlord, Tenant will at the time of such termination pay to Landlord, as damages, a sum representing the amount of the excess, if any, of the total rent and other benefits which would have accrued to Landlord under this Lease for the remainder of the lease term if the Lease terms had been fully complied with by Tenant over and above the fair market rental value of the demised premises for the balance of the term.*
>
> *In lieu of such alternative, at the election of Landlord, Tenant will at the time of such termination pay to Landlord as liquidated damages and not as a penalty, the sum of $ ______________ [or _________ year[s] fixed rent,*

[additional rent, percentage rent] and other charges]. The parties acknowledge that the damages which may be suffered by Landlord are difficult to determine and that the foregoing amount represents a reasonable estimate of such damages.

While many commercial leases that have been drafted and negotiated in recent years may already contain such language, landlords' lawyers should take the opportunity to revisit the lease language of older form leases, and amend them if necessary, to correct any deficiencies in their remedies provisions. Additionally, some landlords or tenants tend to prefer shorter and shorter lease forms for their transactions, and in these cases, leasing lawyers should be sure that in shortening the form of lease, they have not relied solely on more general damage and indemnity language, which after *275 Washington Street Corp.* is insufficient protection for landlords.

In addition to the main holdings of *275 Washington Street Corp.*, the court also observed in a footnote that "[w]here a lease provides for both liquidated damages and indemnification, a landlord, on termination, may not collect on both remedies," citing two of the court's prior decisions from 1915 and 1916.[5] The exclusivity of liquidated damages and indemnification as remedies calls into question the enforceability of certain provisions that sometimes appear in commercial leases, which might be construed to give landlords the right to receive indemnification for a certain period of time and then to elect to obtain a liquidated damages remedy to cover the balance of the term of the lease.[6] Because this specific area of the law in Massachusetts is not yet settled, commercial landlords are well advised to consult with their counsel to ensure their leases are drafted sensibly to minimize the risks associated with this exclusivity principle.

Conclusion

By narrowing the type, scope and timing of remedies that may be available to landlords post-termination under Massachusetts common law, the court has highlighted the importance of specific and careful lease drafting for all leasing practitioners. Landlords cannot rely on the common law of indemnity or contract damages to provide them with post-termination payments in lieu of rent or lump-sum damages representing the amount of future lost rent in the event a tenant defaults under its lease.

As a result, landlords should ensure that their leases expressly provide for at least the following items in order to give them the ability to opt out of the common law rules and pursue the post-termination remedies they expect and have bargained for:

1) Post-termination, the tenant remains responsible for payments in lieu of rent, which payments continue to be due through the date that would have been the expiration date of the lease term.
2) The landlord may elect to accelerate the amounts due post-termination in lieu of rent and collect damages in a lump sum prior to the date that would have been the expiration date of the lease term.

***Jean C. Bowe** is an Associate in Goulston & Storrs, P.C.'s Real Estate group. She works with property owners, real estate developers and lenders and on a variety of matters, including complex acquisitions and dispositions, leasing, financing and development.

****Karen O'Malley** currently focuses her practice on retail and office leasing. In her retail practice, she represents landlords in leasing to national and regional tenants in enclosed mall, lifestyle, mixed-use and transportation-centered projects.

‡Gary M. Ronan advises clients concerning mortgage, lease, and licensing disputes; represents parties in breach of contract and insurance coverage cases; assists developers in appeals of zoning decisions; and defends companies against products liability claims.

[1] *Id*. at 18.

[2] *Id*. at 17.

[3] In fact, the court recently held in *Cummings Properties, LLC v. National Communications Corporation*, 449 Mass. 490 (2007), that an acceleration of rent provision in a commercial lease was enforceable as liquidated damages.

[4] See *Id*. at 22.

[5] *Id*. at 22, citing *Cotting v. Hooper, Lewis & Co.*, 220 Mass. 273 (1915); *Gardiner v. Parsons*, 224 Mass. 347 (1916).

[6] A recent unpublished Massachusetts Superior Court case, *Zuckerman v. Vanu, Inc.*, 2013 Mass. Super. LEXIS 94 (2013), found that a liquidated damages provision in a lease was unenforceable as a penalty, reasoning that the landlord's ability to make the determination of whether to pursue actual or liquidated damages post-termination does not reflect the proper purpose of a liquidated damages provision, which is to provide a fixed, reasonable estimate of damages in advance.

Updates in Energy Use Disclosure Requirements

*Matthew P. Seeberger**
Glazer Weil
Los Angeles, CA

An article in the Summer 2011 issue of *Shopping Center Legal Update* discussed draft regulations regarding required building energy use disclosure by commercial property owners in California. ("California Becomes First State to Require Energy Usage Disclosures by Commercial Property Owners," by attorneys Leslie Criswell, Matthew I. Kaplan and Daniel K. Wright II) These regulations were intended to implement Assembly Bill 1103 ("AB 1103"), codified at California Public Resources Code (the "PRC"), § 25402.10. (The required disclosures are now known as the Nonresidential Building Energy Use Disclosure Program[1] (the "Program"). Two of the main purposes of the Program are to (i) be able to compare a particular building's energy use to that of similar buildings and (ii) check on a building's energy efficiency progress over time.

The required disclosures are in regard to a nonresidential building's U.S.A. Environmental Protection Agency ENERGY STAR® Portfolio Manager ("ESPM") benchmarking data and ratings.

This article will discuss the final regulations for the Program (the "Regulations") adopted by the California Energy Commission (the "CEC"), and will also briefly summarize the status of energy use disclosure programs in other jurisdictions.

Effective Date and Applicability

While the Program was initially scheduled to be effective January 1, 2010, due to extensive input and comment to the original draft regulations, particularly regarding confidentiality of the information (California has strict data privacy laws), the start date has been repeatedly delayed. As of the writing of this article, the Regulations will, commencing on January 1, 2014, require the owner of any nonresidential building with a total gross floor area of more than 10,000 square feet to comply with the Program, and commencing on July 1, 2014, this obligation will be extended to the owner of any nonresidential building with a total gross floor area of more than 5,000 sq. ft. (rather than 1,000 sq. ft. as was initially proposed). (Regulations § 1682).

There is no question that shopping centers are subject to the Program, which defines a "Nonresidential Building" as one that is of a variety of occupancy types as set forth in the California Building Code [Regulations § 1681(i)]. Two of these building types, Business Group B[2] and Mercantile Group M,[3] include within the purview of the Program virtually every occupancy type in shopping centers in the list of businesses that are included—department stores, drug stores, markets and sales rooms, as well as banks, barber and beauty shops, dry cleaning and laundries, motor fuel-dispensing facilities, and professional services.

Disclosures

The disclosures are to be made by means of the following: a Disclosure Summary Sheet, a Statement of Energy Performance, a Data Checklist and a Facility Summary [Regulations § 1683(a) (preamble)]. The disclosures are to be made to (a) a prospective purchaser of the building, no later than 24 hours prior to execution of the sales contract; (b) a prospective lessee of the entire building, no later than 24 hours before execution of the lease; and (c) a prospective lender financing the entire building, no later than submittal of the loan application [Regulations § 1683(a)(1), (2) and (3), respectively]. While "entire building" is not defined, it would be prudent to assume that if a building is structurally separate from adjacent buildings, then compliance will be required. Thus, a "big box" in-line store constructed for a particular tenant could well be a separate building for which disclosure would be required for a tenant (though not for a purchaser or a lender, unless the building footprint was a separate legal parcel). However, a building containing multiple shops would not require disclosures to its tenants.

The Disclosure Summary Sheet describes the three documents mentioned above. The *Statement of Energy Performance* (the "Statement") and the *Data Checklist* (the "Checklist") are standard reports generated by the ESPM: The Statement includes the name and location of the building, the age, the size and rating (if any) of the building, and summaries of energy use and greenhouse gas emissions, while the Checklist summarizes a property's physical and operating characteristics. The *Facility Summary* (a) summarizes both the Statement and the Checklist; (b) compares the building's current energy use to previous performance, if such prior data are available; and (c) provides the score required for the optional ESPM label and the average national energy use for a building with similar characteristics. http://www.energy.ca.gov/ab1103/

AB 1103 initially created concerns regarding privacy, confidentiality and trade secrets in connection with disclosure of energy use information. However, those concerns have been specifically addressed, in that electric and gas utilities are to upload information to the Portfolio Manager "in a manner that preserves the confidentiality of the customer" [PRC § 25401.10(b)], "[n]othing in [the Regulations] permits an owner to use tenant energy use data for purposes other than compliance with [Section 25402.10]" [Regulations § 1683(b)], and "the [CEC] shall treat the data [it obtains] as confidential consistent with state or federal laws" [Regulations § 1684(d)].

Compliance

To comply, an owner should, at least 30 days prior to the anticipated transaction, open a new account or update an existing account [Regulations § 1684(a)] and request that the utilities serving the building[4] upload the information to such account.

Once that has been accomplished, the owner should download the various documents [Regulations § 1684(c)] and then disclose them to the prospective purchaser, lessee or lender by the required date. However, since the documents are only valid for 30 days [Regulations § 1684(c)(4)], the owner should be sure that the transaction is ready to go because delays could cause reports to become invalid, thus further delaying the transaction.

To ensure that it can comply with the Program, a landlord should put disclosure requirements in all new leases, as well as in all lease renewals (the Regulations do not make a distinction between the leases and/or renewal), and should make it standard practice to attempt to put in any amendment of a lease executed before the applicable disclosure implementation date, a requirement of the tenant to agree to the required disclosures. For multi-tenant buildings that may be sold or financed, if a particular tenant is large enough, a landlord may want to approach that tenant to see if it will agree to such disclosures, so that the owner can have as much energy use information as possible for that building. Whenever a disclosure provision is inserted in a lease, the lease should also have remedies in the event the tenant does not comply—not necessarily termination, but perhaps a monetary amount, such as including a provision that imposes a penalty on a tenant that does not deliver documents required by the lease. Also, in the transaction documents for the lease, sale or loan, the owner should ensure that the recipient waives any liability against the owner for inaccurate or incomplete data.

Benefits

While there are no penalties imposed on owners who do not comply with the Program, theoretically there could be an action by the state to force compliance, although it is not clear what that would entail. However, state enforcement may not be needed, as this is a situation in which the market will likely quickly force owners to comply. As buyers, tenants and lenders become familiar with the Program, owners that do not comply may find that the prices, lease rates and ability to obtain financing are negatively affected.

In fact, a study by the Institute of Business and Economic Research at the University of California at Berkeley found that buildings with energy-efficiency certificates have 2 percent higher rental rates than those without; if the higher occupancy rates in the more efficient buildings are factored in, the rates are 6 percent higher.[5] This conclusion suggests that keeping track of energy use may lead to a "win-win-win" situation, whereby a more energy efficient building (i) increases a building's value, (ii) lowers operating costs (a benefit to both landlords and tenants) and (iii) reduces greenhouse gases. Further, a building owner may find itself at a competitive disadvantage with buyers and tenants that are environmentally conscious and want their investments to have the smallest carbon footprint possible. Finally, the fact that an owner may not even know where excess costs are incurred in its building will encourage compliance, because the owner may not know what categories of usage are susceptible to improvement; obtaining the information will accelerate the process of achieving energy savings.

Other Jurisdictions

California was the first jurisdiction in the United States to create a disclosure program. Since then, the following jurisdictions have enacted their own disclosure programs: Austin, TX, and Washington, D.C. (both in 2008); New York City and the State of Washington (both in 2009); Seattle (2010); San Francisco (2011); Philadelphia (2012); and Boston, Minneapolis and Chicago (all in 2013). All the programs are designed to be phased in—starting with large buildings and subsequently requiring smaller buildings to report. The most common minimum thresholds (after all phasing occurs) are 50,000 sq. ft. in Washington, D.C.; New York; Minneapolis; Chicago; Philadelphia). The rest are lower: Austin, TX; San Francisco; and the State of Washington each require reporting for buildings starting at 10,000 sq. ft. Seattle has its threshold at 20,000 sq. ft., and Boston has its threshold at 35,000 sq. ft.

Most of these disclosure jurisdictions require annual reporting; the others only require disclosure in connection with a transaction—usually sales, leases and loans; a couple of cities require reporting to current tenants. Many of the jurisdictional programs are also public. Chicago, the most recent city to enact a disclosure program (September 2013), also requires that—for the first year of reporting, and every third year thereafter—the data must be verified by a licensed professional such as an architect or engineer (or others, as allowed). There are some carve outs, such as buildings under construction or in financial distress (e.g., Chicago), and buildings (i) with a certificate of occupancy that is less than two years old, (ii) less than 50 percent occupied, (iii) taken back in foreclosure or (iv) subject to tax liens (e.g., Minneapolis).

Unlike California, some of the other disclosure programs have enforcement provisions. For example, in the State of Washington, no state agency can sign a new lease or renew a lease in a privately owned building if its ESPM rating is below 75, unless certain energy efficient measures are utilized. In Boston, a poor ESPM rating may result in a building being required to have an energy audit performed (although currently there is no obligation to act on the audit).

Other enforcement mechanisms include the following: In Philadelphia, failure to timely report energy use results in a fine of $300 for the first 30 days, and $100 for each day thereafter. In Boston, failure to timely report results in fines starting at $75 per day, with a maximum of $3,000 per year; non-residential tenants may be fined $35 for each failure to provide information to the building owner.

To get more specific information regarding jurisdictions other than California, it is strongly recommended that local counsel and/or energy experts be retained.

Other Building Types

Energy use disclosure programs are not limited to commercial buildings. Many jurisdictions require public buildings to report their energy use: Hawaii; Utah; Alabama; Minnesota; Ohio; Michigan; Connecticut; Arlington, VA; and Montgomery County, MD. Many jurisdictions also require some residential disclosures: Santa Fe, NM; Austin, TX; Chicago, IL; Alaska; South Dakota; Kansas; Maine; and New York, NY.

Summary

With the economy slowly improving, and the increasing concern about climate change, it seems certain that energy use disclosure programs for commercial properties will continue to be enacted throughout the country. In addition to the jurisdictions with programs in place, a number of other cities have expressed a policy interest in such types of program for commercial properties: San Jose, Berkeley and Santa Monica, CA; Portland, OR; Boulder, CO; Orlando, FL; Cambridge, MA; Burlington, VT; and the States of Vermont and Massachusetts.

Accordingly, shopping center owners should accept the fact that energy use disclosure programs are here to stay. Rather than battling the programs, their time and energy may be better spent seeking to streamline their centers. Currently, there is a patchwork of policies and procedures complying with them, and could create administrative burdens for property owners who own buildings in more than one jurisdiction—which is becoming more common as consolidation of shopping center holdings continues its current trend.

*Matthew P. Seeberger is Of Counsel in Glaser Weil's Real Estate Department. He focuses his practice on the leasing, development, acquisition and disposition of commercial real estate. On behalf of private, public, and institutional developers and landowners, as well as tenants, Mr. Seeberger has handled transactions involving large and small retail centers, as well as office and industrial properties.

[1] Set forth at California Code of Regulations ("CCR"), Title 20, Div. 2, Chap. 4, Art. 9, §§ 1680-1685.

[2] CCR, Title 24, Part 2, Chap. 3, § 304.1.

[3] CCR, Title 24, Part 2, Chap. 3, § 309.1.

[4] All energy utilities, whether public or investor-owned, are required to upload data for at least the most recent 12 months within 30 days of the request (Regulations § 1684(b)). All utilities have also been required to maintain such information since Jan. 1, 2009 (PRC § 25402.10(a)).

[5] A Dutch study obtained similar results, where buildings with lower energy efficiency ratings achieved rents 6.5 percent lower than better performing buildings. [The entire European Union (and Norway) has implemented the EU's Energy Performance Building Directive, passed by the EU Parliament in 2002.]

Case Briefs

*Kathryn Oberto**
Holland & Knight LLP
Orlando, FL

CLASS ACTION

The United States Court of Appeals for the Third Circuit ruled that a retailer's lack of records does not relax a plaintiff's burden to show all the requirements for class certification. Additionally, a trial court may not use a wait-and-see approach in determining numerosity for class certification and may not infer numerosity from the fact that a large pool of possibly qualifying plaintiffs exists. *Hayes v. Wal-Mart Stores, Inc.*, No. 12-2522, 2013 U.S. App. LEXIS 15959; 2013 WL 3957757 (3d Cir., Aug. 2, 2013).

The plaintiff Hayes sued the defendant Wal-Mart, claiming that its related entity, Sam's Club, sold extended warranties to him for items that did not qualify for the warranty. Certain items labeled "as is" are excluded from extended warranties if the item is not covered by a full factory warranty on the date of purchase. "As is" items include display items, returned items and damaged items. Sam's Club gives discounts for "as is" items through a price-override, but does not track the sales of these items in its records.

The plaintiff sued on behalf of himself and others, claiming breach of contract, unjust enrichment and a violation of the *New Jersey Consumer Fraud Act*. The trial court certified a class action for the case, which the defendant challenged—arguing that the plaintiff did not meet his burden to show two main things: 1) an ascertainable class using reliable and feasible methods and 2) a sufficiently numerous class.

As to the first point, the defendant argued that mini-trials would be necessary to determine whether an individual meets the class requirements. The Third Circuit reasoned that while the defendant's lack of records should not hinder class certification, the plaintiff's burden "cannot be relaxed or adjusted on the basis of Hayes' assertion that Wal-Mart's records are of no help to him." This is especially true when the plaintiff did not provide evidence that Wal-Mart had an obligation to keep such records.

As to the second challenge, the Third Circuit confirmed that the trial court may not use a wait-and-see approach based on the plaintiff's promise that he will meet the class requirements—even with a caveat that the court could de-certify the class if the plaintiff fails to meet his burden. Additionally, the Third Circuit noted that the trial court decided there should be enough class members since there were 3,500 price-override transactions; however, these transactions were not exclusively for "as is" items. The Third Circuit concluded: "where a putative class is some subset of a larger pool, the trial court may not infer numerosity from the number in the larger pool alone." This would be mere insufficient speculation.

The Third Circuit also recognized an issue with predominance, but chose not to rule on the issue before the other issues. It also questioned the plaintiff's standing since the plaintiff stated that he did not know whether his purchases had manufacturer's warranties at the time of purchase. The Third Circuit vacated the certification order and remanded the case since the trial court did not have the ability to consider the case in light of another recent decision, *Marcus v. BMW of North America*, 687 F.3d 583 (3d Cir. 2012).

FEES

The United States District Court for the District of Columbia ruled that the Board of Governors of the Federal Reserve System ("Board") overstepped its authority when it passed rules regarding debit card interchange fees and network exclusivity. The court found that the Board inappropriately allowed certain costs in the fee determination process and denied merchants the capability to choose multiple networks for transactions on the same debit card. *NACS v. Bd. of Governors of the Fed. Reserve Sys.*, No. 11-02075 (RJL) (D.D.C. July 31, 2013).

This case grew out of the Board's adoption of a final rule ("Rule") regulating debit card interchange fees and network exclusivity. The Rule was adopted in response to a provision of the *Dodd-Frank Act*, which was passed in 2010 to address rising debit card fees. Sponsored by Illinois Senator Richard J. Durbin, the Durbin Amendment focused on two issues affecting debit card transactions: (i) fees charged or received by debit card networks to compensate entities that issue debit cards to the consumer and (ii) debit card networks that merchants use to route debit card transactions.

Regarding the former, the Durbin Amendment required fees to be "reasonable and proportional" to the issuing entity's transaction costs. To determine what was reasonable and proportional, the Board was directed to consider "authorization, clearance, or settlement" costs of a particular transaction and *not to* consider other costs "not specific" to a particular transaction. Once the standard was established, the Board could then adjust the fee to account for the individual issuer's fraud-prevention costs. Regarding the latter, the Durbin Amendment attempted to prevent issuing entities and networks from restricting the number of networks on which a debit card transaction could be processed. No fewer than two unaffiliated networks were to be made available for each debit card transaction.

The plaintiffs in this case were retail trade associations and individual retailers that either directly accepted debit card payments or represented members that did so. They brought a declaratory judgment action against the Board, arguing that the Board's Rule (i) allowed networks to charge inflated fees by impermissibly considering costs that were not specific to a particular transaction and (ii) permitted issuing entities and networks to restrict the number of networks on which a debit card transaction could be processed to no fewer than two per card—*not* per transaction.

The court granted summary judgment for the plaintiffs. In doing so, the court faulted the Board for adopting a rule that factored certain costs into the fee calculation, including fixed costs associated with processing transactions, as well as transaction monitoring costs and network processing fees. The court also disapproved of the Board's inclusion of an allowance for issuer fraud losses into the fee calculation, instead of authorizing a fraud prevention cost adjustment that would be made on an issuer-specific basis.

The court was equally unimpressed with the Board's network non-exclusivity regulations. Traditionally, there have been two types of debit card transactions: those that require the consumer to enter a PIN and those that require the consumer to sign a receipt. The Board's final Rule allowed issuers and networks to make available only two unaffiliated networks *per card*: one network for PIN transactions and one network for signature transactions. Yet, according to the court, this was not enough. The Board disregarded the plain meaning of the Durbin Amendment by drafting a rule that effectively denied merchants the "ability to choose between multiple networks for each transaction . . . ." The court found that the Board "completely misunderstood" the plain meaning of the relevant federal statute and instructed the Board to replace the invalid portions of the final Rule.

Although the court vacated the offending provisions of the Rule and instructed the Board to replace the invalid portions, the court stayed the vacatur to give the Board time to do so. The Board subsequently appealed the court's ruling to the U.S. Court of Appeal for the District of Columbia Circuit. The stay will remain in place pending final resolution of the Board's appeal to the U.S. Circuit Court.

LEASES

The Supreme Court of New York (trial court) denied motions to dismiss and for summary judgment filed by tenants of a shopping center in which a plaintiff was struck by a shopping cart thrown from a fourth floor common walkway. The court found that issues of fact remained as to whether the defendant tenants breached duties to adequately supervise invitees and to protect or warn against dangers to areas of egress or ingress to a premises. *Hedges v. East River Plaza, LLC*, 2013 NY Slip Op 31727(U) (N.Y. Sup. July 13, 2013).

The plaintiff sued shopping center tenants, among others, for injuries suffered when the plaintiff was struck by a shopping cart thrown from a fourth floor common walkway by two minors. The plaintiff claimed that the defendant tenants owed a duty to take precautionary measures to protect customers or members of the public from dangers of which the tenants were aware and in a position to prevent. The plaintiff alleged generally that the tenants had failed to respond adequately to prior complaints of persons throwing objects off of the common walkway.

With respect to the first defendant tenant, the plaintiff alleged that the tenant attracted unsupervised minors into its store with free beverages, food and candy, and later observed the minors throwing objects off of the walkway. The tenant argued that it did not own, possess or control any shopping carts or the area where the incident occurred and therefore owed no duty to maintain or secure the premises. The court explained that a tenant in possession and control of a premises owes a duty to control persons on the premises "when the business is aware of the need for such control and is in a position to take precautionary measures to protect members of the public from the misconduct" of others. The court further indicated that "the duty of supervision adequate to guard against reasonably foreseeable injury is particularly warranted when, as alleged here, the business invited unescorted minors into its premises." The court denied the tenant's motion to dismiss because the plaintiff's allegations were based on negligent supervision of the tenant's invitees—not the negligent maintenance of shopping carts or the premises.

The second defendant tenant leased the ground floor space across the street from the area where the plaintiff was struck by the shopping cart. As with the first tenant, the second tenant argued that it did not own, possess or control any shopping carts or the area where the injury occurred. The court found that a tenant's duty to provide a safe environment for customers it invites onto its premises extends to the means of egress and ingress onto the premises. Thus, the court stated that if it is reasonably foreseeable that a customer exiting or entering a premises would be exposed to danger, such facts would raise a question concerning a tenant's duty to the customer—even if the duty is merely to warn. The plaintiff provided evidence that she was leaving the second tenant's premises and walking to the parking garage across the street when she was struck without warning by the shopping cart. Based on the foregoing, the court held that issues of fact remained regarding the location of the incident in relation to the second tenant's premises and therefore denied the tenant's motion for summary judgment.

Finally, the court made a point to mention that both tenants attempted to rely on their leases to demonstrate that they were not responsible for general maintenance at the shopping center. However, the tenants failed to produce any witnesses to attest to signatures on the lease or to authenticate circumstantially. Accordingly, the leases were not admissible as evidence in support of the tenants' motions.

A California appellate court has allowed a retail tenant's claims of fraud and bad faith against a landlord to proceed, based on the erroneous estimates for common area maintenance costs that the landlord provided to the tenant prior to lease execution. *Thrifty Payless, Inc. v. The Americana at Brand, LLC,* No. B242573, 2013 Cal. App. Unpub. LEXIS 5070, 2013 WL 3786374 (Cal. Ct. App., July 19, 2013).

A recent interlocutory decision by a California appellate court serves as a reminder to both landlords and tenants of the importance of establishing accurate and reliable formulas for non-fixed rent monetary obligations in multi-tenant shopping centers. Landlords also should observe that lease provisions, which seem advantageously non-specific, may come back to haunt the party deemed to have superior knowledge in a litigation setting.

In 2004, Thrifty/Payless, Inc., doing business as Rite Aid ("Rite Aid"), entered into negotiations with The Americana at Brand, LLC ("Americana"), to occupy retail space in Americana's planned shopping center.

The letter of intent provided that Rite Aid would pay its pro rata share of common area maintenance ("CAM") costs, estimated at $14.50 per square foot annually. However, Rite Aid's representative crossed out the per square foot estimate, and wrote that the landlord would provide a budget to Rite Aid prior to lease execution.

Later, but still prior to lease execution, Americana provided Rite Aid with a budget that indicated Rite Aid's pro rata share of CAM costs would be $14.35 per sq. ft. annually, based on Rite Aid occupying 2.27 percent of the gross leasable area of the shopping center. The landlord's representative, when transmitting the budget, emphasized that it was "preliminary" and reflected "purely estimated values."

The executed lease provided that Rite Aid's pro rata share of CAM costs for each year was to be calculated by dividing the square footage of Rite Aid's premises by the square footage of the then-occupied retail portion of the shopping center. The lease itself did not establish Rite Aid's pro rata share, nor did it estimate Rite Aid's annual CAM costs.

In addition, the lease provided the landlord with discretion to exclude unspecified portions of the shopping center, containing a substantial (but also unspecified) amount of square footage, from Rite Aid's pro rata share of CAM costs because the occupants of such portions of the shopping center would contribute to CAM costs on a basis other than that established for Rite Aid.

In 2009, the landlord charged Rite Aid with CAM costs for the first time. Rite Aid's share of CAM costs was 5.67 percent, as opposed to the 2.2 percent estimate that the landlord provided prior to lease execution, and Rite Aid's actual CAM costs were nearly double the estimated $14.35 per square foot.

Rite Aid filed suit against the landlord, asserting various causes of action—including fraud and breach of the implied covenant of good faith and fair dealing. The appellate court, in overruling the landlord's demurrer to Rite Aid's complaint, determined that all of the counts Rite Aid brought were sufficient as a matter of law.

The court followed established law that an integration clause in a written contract cannot defeat an action for fraud, and then agreed with Rite Aid that a fraud case can be based on inaccurate estimates because "if a party makes an estimate that it knew or should have known was inaccurate, the party can be liable for misrepresentation."

The count alleging that the landlord breached the implied covenant of good faith and fair dealing could proceed because Rite Aid alleged that Americana had improperly exercised its discretion in allocating CAM costs by excluding certain space from the shopping center's gross leasable area when calculating Rite Aids share of CAM costs.

***Kathryn Oberto** is a Partner at Holland & Knight LLP, resident in the firm's Orlando, FL, office.

Rent Distress: A Trap for Unwary Landlords

*Blair Rebane**
Borden Ladner Gervais LLP
Vancouver, BC

Introduction

The laws in a number of Canadian provinces provide commercial landlords with the right to seize and eventually sell the assets of a tenant located on premises in relation to which a landlord is owed arrears of rent. This right is known as the ability of a landlord to issue a rent distress, which is an old self-help remedy originating from the English common law. The particular rules and restrictions regarding the right to distrain for rent arrears are subject to provincial regulatory schemes and must be carefully observed. Several recent judicial decisions have awarded significant damages—including punitive damages—against landlords who have failed to issue and complete a rent distress properly.

It is important to bear in mind that the right to distrain only arises in the context of an existing landlord and tenant relationship. If the relationship is terminated, the right to distrain the tenant's assets is lost.

A common mistake that can have significant consequences occurs where a landlord interferes with a tenant's access to the leased premises or engages in conduct amounting to a termination of the lease prior to taking steps to exercise its right to distrain for rent arrears. If the landlord purports to exercise its right to distrain in the absence of a valid lease, it could be liable for trespass and conversion. The recent case of *Jarvi v. Banwait*, 2013 BCSC 337 (*Jarvi*), serves as a cautionary reminder with respect to the importance of ensuring that commercial landlords properly issue and carry out rent distresses. While the decision relates to a dispute that occurred in British Columbia, it merits close consideration by commercial landlords everywhere.

Background

The tenant in *Jarvi* ran a struggling pigeon farm on property that he rented from the defendants in Abbotsford, BC. Throughout its short time in business, the farm consistently operated at a loss. As a result, the tenant fell significantly behind on his rent. He passed away leaving $17,600 in rent arrears owing to the defendants.

After his death, various members of the tenant's extended family and friends visited the farm from time to time to care for the flock of pigeons. On several occasions, they rounded up a portion of the flock and sent them to a rendering facility for processing. Eventually, however, the tenant's family members were prevented from entering on the property by a representative of the defendants, who told them the pigeons were being taken care of, and they could not come onto the property any more.

Thereafter, the defendants advised the tenant's family that unless and until all rent arrears were paid in full, they would have no further access to the property or to the tenant's possessions and business assets (which, in addition to the flock of pigeons, comprised several barns and pieces of farm equipment, among other things).

The parties both retained legal counsel. When pressed by the plaintiff's lawyer to restore access to the property to the tenant's family members, the defendants' lawyer explained that the defendants were distraining for rent arrears.

Over the course of the next few months, the defendants sent some of the pigeons to a processor, and the rest were either stolen or were subject to predation by cats and rats.

The tenant's sister, as the executor of his estate, brought an action against the defendants seeking general and punitive damages for trespass and conversion regarding the assets of the estate. She claimed the defendants had improperly terminated the lease, and that upon termination, they had lost their right to distrain the tenant's property to recover the rent arrears. As many of the tenant's business assets were now gone, she argued the defendants were liable for the replacement cost, as well as punitive damages for their heavy-handed conduct in terminating the lease and seizing the tenant's property. The defendants filed a counterclaim seeking judgment in the amount of the rent arrears and other relief.

Decision

At trial, the BC Supreme Court considered whether the defendants had in fact terminated the lease, and whether their actions thereafter constituted the torts of trespass and conversion.

Mr. Justice Sewell held that the defendants had terminated the lease, effective immediately, when they expressly denied the plaintiff's representatives access to the property. Citing *Central Equities Ltd. v. Central Interior Hardware Ltd.* [1986] B.C.J. No. 764 (S.C.), and *Beaver Steel v. Skylark Services et al.* (1983), 47 B.C.L.R. 99 (S.C.), he noted that it is well settled that a denial of access to leased property amounts to an eviction, even when the landlord offers to let the tenant back into possession on payment of rental arrears. He found that in this case, the defendants' position was unequivocal: The plaintiff would not be allowed on the property unless and until all rent arrears were paid.

Next, the Court observed that the law is equally well settled that a landlord loses any right to distrain upon termination of the lease. The landlord may sue for such arrears, but its common law right to distrain is lost. Accordingly, the Court found, it was clear that the defendants in this case had no right to retain any of the plaintiff's property after the lease was terminated.

The Court went on to find that the defendants' actions after terminating the lease amounted to the torts of trespass and conversion (at para. 46):

> *In this case, there is no question that the defendants committed a positive act that seriously interfered with the plaintiff's possessory rights when they asserted the right to distrain the goods and prevented the plaintiff's representatives from accessing them. The defendants exercised a right of control over the plaintiff's property that seriously impeded the plaintiff's right to control it.*

In the result, the plaintiff was awarded damages in the amount of $50,000, which the Court determined was the fair market value of the flock of pigeons, the barns and the farm equipment on the date of conversion. Notably, the Court held that it was no answer to the claim that some of the goods were stolen or lost through no fault of the defendants. Rather, as the tort of conversion was complete when the defendants denied the plaintiff access to the goods and asserted a right to distrain them, they were liable for any losses flowing from their actions. However, the Court went on to consider the counterclaim and found that the defendants were entitled to set off the amount of the rent arrears against the plaintiff's judgment.

Key Takeaways

As the decision in *Jarvi* illustrates, the right to distrain for rent arrears can be a trap for the unwary. Accordingly, it is essential for commercial landlords to know the particular rules around issuing and carrying out a rent distress in the jurisdiction(s) in which they operate. If properly carried out, this can be a powerful self-help remedy; however, the consequences of improper execution can be costly. Landlords who fail to observe the rules risk facing claims for trespass, conversion and punitive damages.

As a general rule, landlords who intend to distrain for rent arrears must avoid doing anything to interfere with the tenant's right to possession of the premises: Do not change the locks, do not deny the tenant access to the premises and do not issue a notice of termination with respect to the lease. In addition, it is important to ensure that the amount and value of goods seized are not excessive in relation to the amount of rent that is due. Commercial landlords should also bear in mind that the right to distrain applies only in respect of personal property; it does not extend to fixtures or improvements to the leased premises.

As the consequences for improper rent distress can be severe, commercial landlords are well advised to learn the particular rules in their jurisdiction and consult a lawyer who practices in this area before exercising their right to distrain. With the proper knowledge, landlords can use this longstanding remedy to effectively manage the risk presented by a defaulting tenant.

***Blair A. Rebane** is a Partner and National Leader of Borden Ladner Gervais LLP's Franchise and Distribution Group, as well as the Vancouver Regional Leader of the firm's Auto Industry Group and Real Estate Litigation Group. He practices franchise and distribution law as well as commercial litigation with a focus on commercial leasing disputes. Mr. Rebane has appeared as counsel in court on a large number of franchise and commercial leasing matters and acts for a number of Canada's most significant franchisors, manufacturers, retailers and landlords.