

LEASE DISPUTES

From the title of this session, Lease Disputes, you could be forgiven for thinking that the session will focus on how to litigate or otherwise resolve landlord/tenant disputes. Presumably, the more serious the dispute, the more likely it is to end up in court.

But this is a transactional track course. So the focus will be on how to draft leases that will minimize the likelihood of lease disputes. For this session, we're going to look at some disputes that ended up in court, as reflected by recent Utah court decisions, and brainstorm how the parties could have avoided court with better drafting.

My experience has been in commercial real estate, so that this presentation will not address the issues that are specific to residential lease disputes.

As drafters, our objectives should be:

1. To accurately reflect the deal that the parties have cut in a legally enforceable document.
2. To flesh out issues that the parties did not but should address for the lease.
3. To avoid ambiguities and surprises.
4. To anticipate changes in the parties' relationship or the law and to provide mechanisms for dealing with those changes.
5. To create a process for resolving disputes should they arise.

REPEATED LATE PAYMENTS OF RENT.

The timely payment of rent is near and dear to the hearts of landlords. Yet, out of the goodness of their hearts (and the desire to make the deal), many landlords extend grace periods to tenants to allow for the possibility of a late payment. What the landlord is not expecting is for the tenant to make a business practice out of late rent payments.

For the tenant, the consequences of failing to pay rent are severe including termination of the leasehold estate. Given the consequences, a tenant wants notice that the landlord considers tenant in default and a reasonable opportunity to cure that default.

The Utah Court of Appeals has recently issued opinions on two court cases involving late payment of rent. In each case, better drafting could have avoided surprises or better met the expectations of the parties.

HTC v. Brown Family Holdings, LC, 198 P3d 990 (Utah App 2008)

According to the opinion, the Tenant repeatedly delayed rent payments taking full advantage of language in the Lease which provided that the late payment of rent constitutes a default when the tenant “shall have failed to pay the [r]ent within fifteen (15) days of when due and such failure shall not have been cured within ten (10) days after receipt of written notice from [landlord] respecting such overdue [r]ent payment.”. The Court of Appeals found that repeated late payments were within the parties “expressed intention” to allow for a grace period and not itself a default under the language in the Lease: “If it was intended that the repeated late payment of rent . . . would itself constitute a default, the parties could have so provided in the Lease.” Id. at 994.

TASK: Assuming that the landlord did not really intend to have to send monthly notices of default in order to be paid rent, what language would have better protected landlord?

POSSIBLE SOLUTION: Treat repeated late payments as an “Event of Default” triggering more dramatic remedies (e.g., termination):

Should Tenant default in the timely payment of rent on two (2) or more consecutive months or for three (3) months within any six (6) month period (whether or not any notice is given of such defaults and whether or not such defaults are subsequently cured by tenant within ten (10) days of delinquency), then Landlord may treat the late payment of rent for the third consecutive month or for the fourth month in a six (6) month period as an Event of Default.

[MORE GENEROUSLY] Should Tenant default in the timely payment of rent or other charges payable by Tenant under this Lease so as to necessitate the issuance by Landlord of written notice of default on two or more occasions within any consecutive six (6) month period (whether or not any

such default is subsequently cured by tenant within ten (10) days of such notice) . . . then Landlord may treat such occurrence as an Event of Default.

Red Cliff Corner, LLC v. HH Hunan, Inc. dba J.J. Hunan Sum Fun Food and Knox, 219 P3d 619 (Utah App. 2009).

Tenant repeatedly failed to make timely payments of rent. The Lease provided that the Landlord could terminate if the Tenant defaulted in the payment of rent and the default continued for a period of ten (10) days after written notice (which was defined as a “material default” under the Lease. Separately, the Lease also provided:

Notwithstanding anything herein to the contrary, if Tenant shall default in the payment of any Rent . . . and such default shall continue to be repeated for three (3) consecutive months, or for a total of five (5) months in any period of twelve (12) consecutive months, . . . then notwithstanding that such default shall have been cured within the period after notice as provided in this Section 29, any further or additional default, whether of a similar or dissimilar nature, shall be deemed to be deliberate and Landlord need not afford Tenant an opportunity to cure such further or additional default . . . but shall have the right . . . to terminate this Lease . . .

The Court held that this separate language permitted the Landlord to terminate the Lease after the fourth delayed payment of rent regardless of whether Landlord did or did not give any written notice or opportunity to cure for any of the first three delayed payments.

TASK: Assuming that a tenant may not know that the rental payments are late (e.g., a national retailer mailing its rent checks to the landlord), what language would protect a tenant from a surprise termination (while acknowledging the landlord’s interest in preventing deliberate late payments)?

POSSIBLE SOLUTIONS:

1. Consider spelling out the requirement that notice and opportunity to cure accompanies each of the original defaults:

“If Tenant shall default in the payment of Rent or the payment of other sums due to Landlord under this Lease, and such default occurs on three (3) or more consecutive payment dates or for a total of five (5) payment dates within a calendar year **and Landlord has given written notice and a ten (10) day cure period for each such default**, then notwithstanding the fact that such defaults shall have been cured within the time permitted for cure, any further default in the payment of Rent or other sums due Landlord under this Lease **within a twelve (12) month period** shall be deemed to be deliberate and Landlord need not afford Tenant the opportunity to cure any such further or additional default but shall

have the right, at Landlord's option, to terminate the Lease by giving Tenant three (3) day written notice."

2. Consider requiring the Landlord to spell out the consequences of repeated default in the default notice:

"If Tenant shall default in the payment of Rent or the payment of other sums due to Landlord under this Lease, and such default occurs on three (3) or more consecutive payment dates or for a total of five (5) payment dates within a calendar year **and Landlord identifies in all capital letters in a written notice to Tenant that the default is the second or third consecutive default and that any further default within a twelve (12) month period shall entitle the Landlord to terminate this Lease or that the default is the second, third, fourth or fifth such default and that any further default within a twelve (12) month period shall entitle the Landlord to terminate this Lease**, then notwithstanding the fact that such defaults shall have been cured within the time permitted for cure, any further default in the payment of Rent or other sums due Landlord under this Lease shall be deemed to be deliberate and Landlord need not afford Tenant the opportunity to cure any such further or additional default but shall have the right, at Landlord's option, to terminate the Lease by giving Tenant three (3) day written notice."

MISSING TERMS.

At what point does a lease become unenforceable for failing to include essential terms?

Nielsen v. Gold's Gym, 78 P.3d 600 (UT 2003).

Here, the lease was silent as to whether Landlord or Tenant was responsible to pay for the cost of tenant improvements. The Court found that “terms governing payment of tenant improvements are essential to the lease” and accordingly, that the missing term rendered the Lease ambiguous and therefore unenforceable. The court found no evidence of industry customs or standards to aid the court in determining responsibility for payment.

TASK: What are the essential terms for a Lease?

SOLUTIONS:

1. Attempt to catalog all of the possible essential terms:

“To be enforceable, the agreement should name the parties, describe the property, the period of time for the lease, and the payments required. Other common provisions include repair responsibilities, rights concerning assignment or subleasing, and deposit requirements.” Thomas and Backman, Utah Real Property Law.

What about:

Duty of Repair (commercial leases)?

Condition upon occupancy? Condition upon termination of Lease?

2. Establish terms by incorporating existing custom or statutory presumptions:

i. Duties established by statute: (a) Landlord's Covenant of Quiet Possession; (b) Implied warranty of habitability (Residential); (c) Fit Premises Act (Residential).

ii. Duties or Rights established by common law. For example, in the absence of a contractual prohibition, a tenant may freely assign the lease or sublet the leased premises.

iii. Duties established by custom: For example, whether leases or memoranda of leases are recorded and at whose cost.

MECHANICS LIENS.

Is it enough to provide that a tenant is responsible for repairs if the mechanics lien statutes make the landlord ultimately responsible for payment to the contractor?

Advanced Restoration, L.L.C. v. Priskos, 126 P3d 786 (UT App. 2005).

In this case, a contractor sued Landlord and Tenant to recover payment for repairs undertaken at the request of Tenant. At the trial court level, the parties agreed that if a tenant is acting as an “implied agent” of a landlord, the landlord would be liable to a contractor under Utah’s mechanics lien statutes. That analysis ordinarily focuses on whether the improvement is really for the benefit of the landlord rather than the tenant.

Here, the Landlord argued that the Tenant was not an implied agent because Tenant was obligated to repair the Premises. The court was not persuaded that the lease clearly obligated Tenant to repair the premises. Instead, in consideration of the fact that the Tenant was on a month to month basis (so that landlord could terminate the lease with 30 days notice) and that the repairs were extensive, the appellate court reasoned that the repairs were primarily for the benefit of the landlord.

The lease did require the tenant not to permit liens to be recorded against the property and to indemnify the landlord against liens, however, the court determined that the tenant discharged that obligation by proposing a settlement with the contractor which failed because the tenant and landlord could not agree on the mechanics of a simultaneous exchange of the insurance check and the contractor’s lien waiver.

TASK: From the facts recited in the case, the landlord made life more difficult for itself by contacting its own insurance company to request coverage and by failing to consummate the settlement, but as to drafting, could Landlord better protect itself from mechanics liens for work that is the obligation of the tenant?

POSSIBLE SOLUTION: What about requiring prior consent before any repair over a threshold amount or within the last several years of a lease? What about a disclaimer that any repairs without such consent are at the tenant’s sole risk and for their sole benefit?

COVENANT OF CONTINUOUS OPERATION

When can a landlord expect that the obligations of good faith and fair dealing to imply covenants not spelled out in the express language of a lease? When can a tenant rely on the absence of an express obligation to protect it against a court implying the existence of that obligation?

Oakwood Village, LLC v. Albertson's, Inc., 104 P.3d 1226 (UT 2004).

In Oakwood, the landlord contended that the tenant had an obligation to continuously operate notwithstanding the fact that the lease was silent as to whether such a covenant existed. In resolving the parties' arguments, the Supreme Court held that a covenant of continuous operation may be inferred from the language of the lease and the conduct of the parties "where there is a "legal necessity" to imply a restrictive covenant "to effectuate the intent of the parties".

According to the court, an inference supporting a covenant of continuing operation can be drawn from: (1) whether there is percentage rent; (2) whether there is a use clause specifying tenant's permitted use of the premises; (3) whether the right to assign or sublet is restricted; (4) whether the tenant had an unrestricted right to remove fixtures; (5) whether abandonment (going dark) is a specified event of default; and (6) whether tenant had an obligation to rebuild after an event of casualty or condemnation.

Other factors that could support an inference include: (a) whether the covenant of quiet enjoyment is specifically addressed at tenant's intended use; (b) whether landlord is obligated to obtain governmental approvals or represent that zoning and approvals have been obtained for a specific tenant use; (c) if the lease includes a penalty rent (say for breach of cotenancy requirements) that is based on sales.

TASK: How to protect a party's expectation as to continuous operation?

POSSIBLE SOLUTION:

LANDLORD: From the landlord's perspective, an express covenant of continuous operation would obviously address this concern. Lacking the bargaining strength to extract that covenant from the tenant, a landlord could negotiate for a recapture right. If the intent of the tenant (as here) is to protect a new location from competition, coupling the recapture right with a use restriction for a limited period of time may be more palatable to the tenant.

TENANT: From the tenant's perspective, it must be uncomfortable to rely on a balancing of factors to determine if a covenant of continuous operation could be inferred. Wouldn't a well drafted disclaimer have benefitted this tenant:

Tenant is not obligated to continuously operate or operate for any period of time a _____, a retail store or any other business within the Leased Premises.

Nothing herein (including any obligation of landlord to obtain approvals, construct improvements or any obligation of tenant to maintain, restore or repair the Leased Premises or any restriction on the Tenant's use of the Leased Premises) shall be interpreted to imply an obligation of Tenant to operate a business within the Leased Premises or to prevent Tenant from closing its business on the Leased Premises. Landlord acknowledges that Tenant's obligations are limited to those expressly set forth herein and that there is no implied covenant requiring Tenant to operate a business within the Leased Premises.

EXERCISING OPTIONS TO RENEW

U.S. Realty 86 Assocs. V. Security Investment, Ltd., 40 P.3d 586 (UT 2002)

Tenant relied on faulty lease abstracts prepared by a management company and failed, as a result, to timely exercise a renewal option. The Supreme Court affirmed that the failure to timely exercise an option to renew will not be equitably excused where the mistake is the result of the tenant's own negligence.

TASK: This is a classic example of the drastic consequences of a plain old mistake. The more dramatic the consequences, the more protection that the drafters should want to build into a lease.

POSSIBLE SOLUTION: Requiring the Landlord to give notice that it had not received a renewal notice places a small burden on the landlord in comparison to the larger burden on the tenant of losing the option terms altogether:

Tenant may exercise the option to extend the Term for five (5) periods of five (5) years each by giving written notice to Landlord at least 180 days prior to the end of the then current Term. Notwithstanding the foregoing, if Tenant fails to give notice by such date, Tenant's time to give notice of its exercise shall continue until the date which is fifteen (15) days after Landlord notifies Tenant, in writing, that Tenant has failed to make exercise the option. If Landlord does not give such notice to Tenant at least sixty (60) days before the expiration of the Term, the Term will automatically extend beyond such expiration to the date sixty (60) days after the earlier of: (a) Landlord's notice to Tenant of Tenant's failure to exercise its option to extend, or (b) Tenant's notice to Landlord that it will not exercise its option to extend.

FROM THE WORLD OF RETAIL:

CAM BUDGETS AND PAYMENTS

In the wake of the recession, tenants are paying more attention to their CAM obligations and picking more fights with Landlords over the charges for maintenance.

LANDLORD'S PERSPECTIVE: Normally, Landlord would want to be reimbursed all common area costs other than a negotiated list of excluded items. For example, a landlord oriented provision could define reimbursable CAM costs as: "All costs for maintaining, operating and repairing the common areas." The Tenant will then propose a lengthy list of exceptions.

TENANT'S PERSPECTIVE: Normally, Tenant would like to reimburse Landlord for only those specific costs identified in the Lease. For example, a tenant oriented provision could define reimbursable CAM costs as: "The reasonable out of pocket, arm's length, third party expenses actually incurred by Landlord in sweeping, restriping, removing ice and snow from and repairing the parking lot, maintaining, repairing and operating the pylon sign, and maintaining and irrigating the landscaping in those areas shown on the site plan as "CAM Maintenance Areas". The Landlord will then propose a lengthy list of related maintenance items and catchall provisions.

In either event, the parties should attempt to avoid the surprise categories of CAM expense.

BATTLEGROUND ITEMS:

- Administrative Fee

- Personnel Costs

 - Lease Administration

 - Day Porter Charges

- Capital Improvements

- Insurance

 - Property v. Liability

- Security

- Costs of Leasing or Advertising the Center

 - Sign costs (e.g., Developer's Plaza")

- Seasonal Costs

 - Xmas lights

Audits: Prohibitions on percentage of success or unlicensed outside auditors.

LIST OF CARVE OUTS (from a hypothetical tenant's perspective):

Costs that are related to development, construction or ownership of the Center not maintenance:

Costs incurred in connection with the acquisition of the land comprising the Shopping Center and the original construction of the buildings and improvements of the Shopping Center and any cost incurred to correct defects in the original construction of the buildings and improvements of the Shopping Center.

Interest and amortization under mortgages or any other secured or unsecured loan payable by Landlord, and financing and refinancing costs, including fees paid by Landlord to obtain financing or refinancing such as origination fees or brokerage commissions. Any rent loss or reserves for rent loss.

Costs of a capital nature, including, without limitation, parking lot repaving.

Payments for rented equipment, the cost of which would constitute a capital expenditure not otherwise permitted as CAM Costs if the equipment were purchased.

Depreciation.

Income, excess profits or franchise taxes or other such taxes imposed on or measured by the income of Landlord from the operation of the Shopping Center.

All costs and expenses of putting all or any portion of the Shopping Center into compliance with the requirements of the Americans with Disabilities Act.

Any payments of judgments or liens against Landlord or the Shopping Center.

Rent under any ground lease or lease in a sale/leaseback transaction.

Any governmental charges or penalties and all other costs incurred by Landlord to clean up, remediate, remove or abate any Hazardous Materials released, stored or deposited in the Shopping Center except to the extent caused by Tenant.

Excess Costs

Any costs and expenses payable to Landlord or to an affiliate of Landlord to the extent that such costs and expenses exceed competitive costs and expenses for materials and services by unrelated persons or entities of similar skill and experience.

Costs associated with leasing efforts or that benefit the landowner more than the tenants :

Costs of sign panels in or on the Shopping Center identifying the owner of the Shopping Center.

Seasonal decorations.

Any advertising or promotional expenses relating to the Shopping Center and the acquisition or maintenance cost of any objects of art displayed in the Shopping Center and the expenses relating to any architectural or landscaping feature (e.g., clock tower, water fountain etc.) unless expressly required by a governmental entity as a condition to Tenant's occupancy.

Administrative Costs:

Landlord's cost to manage or administer the common area maintenance and its corporate overhead and general administrative expenses (including any audit fees).

Expenses relating to Landlord's officers and employees (including any wages or benefits).

Expenses or premiums related to property insurance or liability insurance maintained by Landlord or the Maintenance Director.

Expenses incurred in leasing space (obtaining new tenants or retaining existing tenants), such as legal expenses, brokerage commissions, architectural or engineering fees, or advertising or promotional expenses.

Costs incurred in connection with the enforcement of leases, including attorneys' fees or other costs and expenses incurred in connection with summary proceedings to dispossess any other tenant in the Shopping Center.

Entertainment, transportation, meals and lodging of anyone.

Interest or penalties paid by Landlord (except to the extent caused by Tenant's failure to timely pay CAM).

Expenses incurred by Landlord to sell, convey or otherwise transfer all or any portion of the Shopping Center.

Costs that should not be allocated among all Tenants:

Costs for: (i) services not benefiting tenants of a majority of the floor area within buildings within the Shopping Center; and (ii) any expenses associated with any special requirements of a particular tenant in connection with the Common Areas.

Leasehold improvements (including painting) made in tenant premises for tenants or occupants or made in order to prepare for occupancy by a new tenant.

Costs, charges and expenses relating to the maintenance of any food court area of the Shopping Center.

Costs incurred that are directly related to any violation by Landlord or any tenant of the Shopping Center (other than Tenant) of the terms of any lease or any laws, rules, regulations or ordinances applicable to the Shopping Center.

Costs incurred as a result of any act, omission, negligence or default of the Landlord or any other occupant in the Shopping Center.

Expenses related to parking operations associated with the Shopping Center such as valet and shuttle services.

No Double Dipping

Costs for utilities paid directly by Tenant.

Costs to the extent reimbursed by an insurer, condemnor, by warranty, or by any other person.

Expenses for repair or replacement paid by proceeds of condemnation awards and any costs due to casualty that is covered, or required to be covered, by insurance hereunder.

Services that some Tenants do not want provided at their cost:

Costs for any security to be provided in the Shopping Center.

Expenses for trash removal and/or day porter services.

The cost to correct conditions or the charges and penalties arising from conditions that were existing in the Shopping Center prior to the effective date of the Lease.

COTENANCY

Typically, a co-tenancy covenant permits a tenant to terminate or pay reduced rents if either a percentage of the leasable space in a shopping center is vacant or if certain key tenants or tenant categories are no longer operating in the shopping center. In today's retail environment, it is not unusual for a national tenant to enforce its cotenancy remedies, if not to undertake a wholesale review of its leases to determine if any co-tenancy provisions have been violated. Landlords are naturally suspicious that the Tenant is taking advantage of the vacancy rates as opposed to actually suffering harm as a result of the lack of co tenants (as opposed to the market itself).

Assuming that a tenant wants relief when a shopping center is going dark and assuming that a landlord does not want to provide a remedy if the tenant is not actually suffering damages, what kinds of provisions should the lease include?

1. How does the Tenant learn that the Co-Tenancy requirements are not met:

Is Landlord obligated to inform Tenant that the co-tenancy requirement is no longer satisfied or is the Landlord just obligated to respond to inquiries?

Is Tenant permitted to audit the Shopping Center for compliance?

2. What are the remedies for a breach of the Co-Tenancy requirement?

Alternate Rent

Percentage of Actual Sales (reflects impact of co-tenancy failure but implies a Covenant to Operate?)

Diminished Rent Amount (is unrelated to actual impact of co-tenancy).

Termination with a Burn Off (Either terminate or go back to full rent)

If at any time after the _____ lease year, Landlord is in violation of the Co-Tenancy Requirement, Tenant shall then have the right following written notice to Landlord, to pay to Landlord Alternate Rent in lieu of Base Rent until the end of the calendar month in which the Co-Tenancy Requirement is satisfied. If the violation of the Co-Tenancy Requirement continues for a period of twelve (12) consecutive months, Tenant shall have the right to terminate this Lease by written notice delivered to Landlord within thirty (30) days following the end of the such twelve (12) month period. If Tenant fails to deliver written notice to Landlord exercising such termination right within thirty (30) days after the end of such twelve (12) month period, then such termination right shall be deemed waived and Tenant shall resume the full payment of Base Rent thereafter.