Commercial Real Estate Lease Defaults and Remedies: Minimizing Disputes and Avoiding Litigation

Structuring and Negotiating Enforceable Lease Provisions to Protect Landlords and Tenants

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Today’s faculty features:

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Demonstrational Objectives

The ideas and views expressed by Mr. Feir or Mr. Vallas are for demonstration and educational purposes only.

The laws of each state may differ from those being discussed today.

Attendance at this webinar does not create an attorney/client relationship with either Mr. Feir or Mr. Vallas.
Not Everything Will Go Smoothly
Types of Defaults

• Failure to Pay Rent
• Failure to Open and Operate
• Use Restrictions
• Going Out of Business Sales
• Bankruptcy
• Mechanics Liens
• Return of Condition
Collect the Facts

- WHAT
- WHO
- WHEN
- WHY
- HOW
- WHERE

SOLUTION
Evaluate Loss and Risk
Now What?

• What are the landlord’s remedies?
• Does the tenant have money?
• Is the landlord willing to take possession of the premises back?
• Is there a sense of urgency?
Should I file suit?

“I must say that as a litigant I should dread a lawsuit beyond almost anything short of sickness and death.”
—Learned Hand

“Lawsuits are expensive, terrifying, frustrating, infuriating, humiliating, time-consuming, perhaps all-consuming.”
—David Luban
Coin Flips, Straws, & Polls
Alternative Dispute Resolution
What and When to Use

• Settlement Meeting
• Mediation
• Arbitration
• Private Judge
Common Motivations

- Silver bullet
- Save money, time, and people power
- Finality
Arbitration Issues

• Selection
• Costs
• Rules, discovery, and methods to compel
• Governing law and venue
• Enforcing the result
Default Notices

• In Writing
• Pertinent Dates and/or Time Periods
• Informs the Tenant of Basis
• Description of the Premises
• Proper Identification of the Tenant and Others
• Landlord’s Contact Information
Notice Survival Tips

- Check the lease and the statute
- Include everyone with an interest
- Serve under the lease, statute, and court rules
- Everyone gets their own notice
- It is OK to be redundant
- Confirm the address
Scenario 1: Rent Defaults
What Not to Do

No Self Help!
Don’t Change the Locks

• Many leases provide that upon an event of default, the landlord has the right to re-enter and take possession of the premises.
• These provisions are not enforceable in most states.
• A landlord should not re-take possession of the premises unless it is memorialized in writing, either through an agreement or a court order.
Eviction Proceeding

- Evictions are generally governed by statute.
- They is summary proceedings which enable landlords to gain relief more quickly than in “normal” proceedings.
- Judges treat it as tenant-friendly system. Most questions are viewed favorably for the tenant.
  - If the landlord does not follow the exact statutory requirements, the case will be dismissed and the landlord will need to start over.
Eviction Proceeding: Pros & Cons

Pros:

• Very powerful tool – a landlord can shut down a tenant’s business and evict the tenant from its premises for even a slight infraction under the lease.
• Relatively fast process. It is a matter of months, not years, from start to finish.
Eviction Proceeding: Pros & Cons

Cons:

• In many states commercial evictions and residential evictions are handled by the same judges in the same courtrooms. Some judges are unaccustomed to interpreting commercial leases or sophisticated questions of law.

• If an issue is not germane to the tenant’s right to possession, most courts cannot not hear it.

• Typically must file in county where premises is located.
Breach of Contract Actions: Pros & Cons

Pros:
• Just about any issue can be raised, including claims for future rent, claims against guarantors, or claims related to other leases with the same tenant.
• Courts are typically more accustomed to complex commercial disputes.
• More flexibility when it comes to venue
Breach of Contract Actions: Pros & Cons

Cons:

• Cases tend to proceed slowly.
• The landlord does not have as much settlement leverage because the tenant it can continue to operate – and not pay rent – while the case is pending.
Can I Get Future Rent?

• In most states, the obligation to pay rent stops when tenant is dispossessed from the premises . . . unless the lease provides otherwise.

• The lease should provide that:
  – The landlord can recover future rent as it accrues after possession is terminated;
  – The landlord can accelerate all future rent; and
  – The landlord can recover the “rent differential”.

• The lease should also address the landlord’s duty to mitigate damages.
Non-Monetary Defaults

- Operating Covenants
- Going Out of Business Sales
- Use Restrictions/Radius Restrictions
- Mechanics Liens
- Bankruptcy
- Failure to Return in Proper Condition
Non-Monetary Defaults

• Most of commercial leases impose a 20 or 30 day cure period for non-monetary defaults.
  – This can be problematic for defaults that cause immediate harm.

• Examples:
  – “Going out of business sale”
  – Failure to have proper insurance
Scenario 2: Operating Covenants
Failure to Open and Operate

• Most leases require the tenant to remain open and to operate for specific hours.

• If the tenant fails to operate as required, tenant is in default.
  – Some commercial leases do not give the tenant a cure period for the failure to open.
  – Tenant is also required to pay “within ten (10) days of demand” some amount as “Additional Rent” due for each day tenant is closed.
  – If the tenant does not pay the Additional Rent within this period, the tenant is in default. The landlord now has a monetary default as well.
Scenario 3: Use Restrictions
Issues Related to Use Clause Defaults

- Rules of Construction
- Third Party Interests and Nuisances
- Waiver/Estoppel
- Illegal Uses
- Assignment/Subletting
Scenario 3: Radius Restrictions

• Many leases contain a radius restriction preventing the tenant from opening another store within a defined area.
• Eviction proceeding may not be helpful because the tenant may want out of its lease in favor of a competing location.
• What remedies are provided in the lease? Injunction? Combining “Gross Sales”? 
Scenario 4: GOB Sales
Going Out of Business Sales

• An eviction case is unhelpful – the tenant is already leaving!

• Is there harm to other tenants?
  – Cannibalizing sales
  – Diminishing reputation of the shopping center

• The landlord’s remedy might be to seek a temporary restraining order, stopping the sale
Scenario 5: Bankruptcy

• Despite what the lease says, the filing for bankruptcy is not a default under the lease.

• Bankruptcy has four primary impacts on a landlord:
  – The Automatic Stay
  – Payment of post-petition rent
  – The tenant’s option to reject the lease
  – An assignment of the lease can be forced on the landlord despite a contrary lease provision.
The Automatic Stay

• All collection actions must stop as soon as the tenant files for bankruptcy.

• For all practical purposes, if the landlord does not have an order terminating Possession or the lease has not expired by its terms, any efforts to enforce the lease are over.
Post-Petition Rent: When Will I Get Paid?

• Tenant must timely perform its post-petition obligations under the lease (e.g., pay rent) until the is assumed or rejected.
  – Any performance due within the first 60 days may be delayed, for “cause,” until anytime during that 60-day period, but not beyond it.
• If the debtor does not perform, the landlord can file a motion seeking to require performance.
What Happens to the Lease?

• The tenant has 120 days after the date it files for bankruptcy to decide what it wants to do with the lease.

• The period can be extended 90 days for “cause” but after that only with the landlord’s consent.

• During this 120-day period, the tenant-debtor is required to pay its rent in the ordinary course of business.
What are the Tenant’s Options?

• Bankruptcy Code offers a tenant-debtor the option of:
  – “Rejecting” the lease,
  – “Assuming” the lease, or
  – “Assuming and Assigning” the lease.
Rejection of the Lease

• “Rejection” means that the tenant wants out of the lease.
  – Generally, the tenant-debtor commits to vacate the premises by a certain date.
    • The landlord gets a claim in the bankruptcy case of one year’s worth of rent or 15% of the rent remaining through the term, not to exceed 3 years, whatever is more.
    • This claim is a general unsecured claim and typically pays only cents on the dollar.
Assumption of the Lease

• “Assumption” means the tenant wants to keep the lease.
  – The tenant must cure all defaults that occurred before and after the filing of the bankruptcy. The landlord will be paid in full, but not necessarily right then.
  – The tenant must provide “adequate assurances of future performance” – demonstrate that the tenant can pay rent moving forward, although there is no guaranty.
  – If the tenant later “rejects” the lease, the landlord is entitled to no more than two years of post-rejection rent.
Assumption & Assignment Lease

• “Assumption and Assignment” is the same as “assumption” with one addition ... the tenant can assign its lease to a third party, sometimes over the landlord’s objection.

  – The Bankruptcy Code eliminates the landlord’s discretion and/or consent rights in an anti-assignment clause.

  – “Use” clauses will generally be honored, subject to certain limitations.
Important Dates to Remember

120-day Grace Period:
Tenant decides whether it wants to assume, reject, or assign the lease

Tenant Files Bankruptcy

30

60-day
Post-Petition rent must be paid.

90

120-day
Extension may be granted for “cause”.

90-day extension
Scenario 6: Return of Condition
Defaults Related to the Return of Condition

• Preventing issues prior to the tenancy
• What does reasonable “wear and tear” look like?
• A related problem: when a tenant leaves a secured lender’s collateral in the premises
Scenario 7: Construction and Liens
Defaults Concerning Construction

- Know the players and their finances
- Know the scope
- Know the funding options
- Attempt pre-con lien releases
- Secure backup payment sources
- Be vigilant about lien management
What is a Mechanics Lien?

• A mechanics lien is like a mortgage on the property.

• It gives the lien claimant a legal interest in the property. A lien claimant can foreclose on its interest and sell the property to satisfy the lien amount.
Mechanics Liens: Take Them Seriously!

• Some mechanics liens can “prime” the mortgage.
  – This means that if the property is sold or refinanced, the mechanics lien will be paid before the mortgage.
  – This can put the mortgage in default and cost the landlord thousands, if not millions, of dollars in fees and interest to its lender.