

Defaults and Remedies in Retail Leases

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Introduction

The slow economy has many retail tenants evaluating store closures, abandoning store openings and even seeking bankruptcy protection. Leases for the subject stores have a material impact on these decisions. This article briefly summarizes the key issues affecting landlord and tenant defaults and their respective rights and obligations under common lease provisions.

What is a Default

Obviously, a failure to perform a lease obligation constitutes a default. However, many leases contain notice and cure rights in favor of both parties. Most leases also contain detailed provisions governing the method for delivering notices, including a notice of default, between the parties. Until the non-breaching party gives the proper notice and opportunity to cure, an actionable default has not technically occurred. Leases may also carefully limit what type of non-performance constitutes a default by including "materiality-qualifiers". Furthermore, the failure to insist on strict performance of all lease provisions could lead to a waiver of the right to enforce them in the future. Carefully drafted leases, address all of these issues by specifically defining the actions or inactions that constitute defaults, providing a clear procedure for providing notice of defaults and even providing that a waiver of one default does not waive the right to insist on performance in the future.

Typical Lease Remedies

Retail leases are contracts *and* instruments affecting the possession of real property. As such, general contract remedies are available to the non-breaching party. However, in most default situations, the tenant still has possession of the premises which the landlord would like to recover. As with all contract breaches, the non-breaching party must make reasonable attempts to mitigate its damages. In the lease context, this generally means attempting to re-let the premises. Depending on the language of the lease, if the landlord repossesses the premises and/or re-lets it, those acts could terminate the lease and the tenant's obligations to pay any future rent not yet due. While it may be possible in some leases, particularly those with less sophisticated "local" tenants, to have an acceleration clause allowing the landlord to pursue all rent remaining on the lease immediately upon a default, most experienced tenants will not agree to this. Instead, they may agree that if the landlord repossesses the premises, such action will not be deemed a termination of the lease and the landlord may make such renovations as it deems necessary to re-let the premises for the benefit of the tenant's account. Any positive difference between the old and new rent being kept by the landlord and any negative difference paid by the tenant.

The parties must consider the terms of such a re-letting as well. The landlord will want to re-let to any tenant on any reasonable terms whereas the tenant may want the landlord to re-let to the first willing tenant. At the very least, the landlord must retain the right to reject potential replacement tenants who are not creditworthy or whose business does not provide the right tenant mix for the shopping center. The tenant will also want such a re-letting to terminate its obligations under the original lease and the landlord will want the original tenant to remain as a virtual guarantor of the tenant's obligations.

Bankruptcy

Pre-Bankruptcy

In addition to the many challenges faced by the Landlord upon default by the tenant, the landlord will have to climb an even steeper hill if the tenant files for bankruptcy protection. A landlord can use several methods prior to the tenant filing bankruptcy, however, to possibly avoid bankruptcy altogether.

The first method is to terminate the lease prior to the filing of a bankruptcy petition. This requires a landlord to be proactive and aware of the tenant's financial condition at all times. A diligent landlord will act quickly upon an event of default and pursue the applicable termination and eviction action. Termination of the lease alone is not sufficient. The landlord must also take possession of the premises. If the tenant is still in possession on the date of the bankruptcy petition, the automatic stay can prevent the landlord from evicting the tenant.

Another option is for the landlord to obtain a guaranty from a solvent third party that is not closely related to the tenant-debtor. The Bankruptcy Code only prohibits action against the debtor and the debtor's estate. An action on a guaranty against a non-related third party guarantor is not prohibited and may give the landlord a viable option for collection.

A third option is a judgment for possession. Pursuant to 11 U.S.C. § 362(b)(22), the automatic stay does not bar an eviction action if the landlord obtained a judgment for possession prior to the filing of the bankruptcy petition. Under some circumstances, a tenant-debtor may obtain a limited 30 day stay, but only if the debtor satisfies any arrears in rent by the end of such 30 day period. Again, a landlord must be proactive in its management of the premises, and should also consider negotiating with the tenant to reduce the past due amount in exchange for a voluntary judgment for possession.

Bankruptcy

If the landlord is not successful in avoiding the bankruptcy, it should be aware of certain basic bankruptcy rules.

When a tenant files for bankruptcy protection, the "automatic stay" effectively halts all collection and/or eviction proceedings against the tenant-debtor. The debtor's interest in the lease will become "property of the bankruptcy estate." The effect of this is that the landlord's self-help and eviction rights are halted. Even if the landlord was successful in obtaining a judgment, the automatic stay precludes the landlord from enforcing the judgment.

A basic understanding of the most common steps in bankruptcy can assist the landlord in protecting its interest. Upon the filing of a bankruptcy petition by a commercial tenant, the bankruptcy trustee or the debtor-tenant is required to:

- (1) Begin performing the tenant's obligations under the lease immediately after filing, unless the court extended the time for doing so for up to 60 days for cause pursuant to 11 U.S.C. § 365(d)(3);
- (2) Assume or reject the lease within 120 days after the order for relief, unless the court extended that time (the landlord's written consent is required to extend that time an additional 90 days) pursuant to 11 U.S.C. § 365(d)(4); and
- (3) Surrender the property to landlord at the end of the 120-day to 210-day period, unless the lease had been assumed or the period extended with landlord's agreement, pursuant to 11 U.S.C. § 365(d)(4).

The debtor-tenant also has the option to assign the lease to a third party if certain conditions are met pursuant to 11 U.S.C. § 365(f)(1). If the lease is assumed, the trustee must cure any existing defaults and provide "adequate assurance" of future performance to the landlord. For leases in a "shopping center," the landlord is entitled to "adequate assurance" that (1) the financial condition and operating performance of any assignee be similar; (2) percentage rent will not decline substantially; (3) all other provisions of the lease apply, such as exclusive use clauses; and (4) the tenant mix or balance at the shopping center not be disrupted. "Adequate assurance" that a landlord will be compensated for any pecuniary loss is a condition to the assumption of a lease of real property in a shopping center.

If the lease is assumed, a landlord-creditor must continue its vigilance and monitor the bankruptcy case closely and should consult with a bankruptcy attorney. In most cases, if the lease of commercial property provides for the landlord to recover its attorney's fees upon breach by the tenant, the landlord is entitled to recover, as an expense of administration, fees necessary to enforce the landlord's post-petition rights in the bankruptcy case. The language used by the lease may affect the landlord's ability to recover these fees. Ideally, the lease should provide that the tenant is obligated to pay these fees as they are incurred by the landlord.

Sample Lease Provisions

Several sample lease provisions relating to events of default and consequent remedies follow. These provisions assume that the tenant agreed to operate continuously and that the tenant is obligated for the payment of percentage rent.

“Event of Default” Defined. Tenant shall be in default of its obligations pursuant to this Lease (each, an “Event of Default”) upon the occurrence of one or more of the following:

1. Failure of Tenant to pay any one or more of the installments of Rental, or any other sum provided for in this Lease as and when the same become due;
2. The removal, attempt to remove or permitting to be removed from the Premises, except in the usual course of trade, the goods, furniture, effects or other property of Tenant or any assignee, or sub-tenant of Tenant;
3. The levy of an execution or other legal process upon the goods, furniture, effects or other property of Tenant brought on the Premises or upon the interest of Tenant in this Lease;
4. The filing of a petition in bankruptcy, a petition for reorganization by or against Tenant;
5. The appointment of a receiver or trustee, or other court officer, for the assets of Tenant;
6. The execution of an assignment for the benefit of creditors of Tenant;
7. The vacation or abandonment by Tenant of the Premises;
8. The use of the Premises for any purpose other than for the Permitted Use;
9. Failure of Tenant to exercise diligent effort to produce the maximum volume of sales;
10. The assignment by Tenant of this Lease or the re-letting or subletting by Tenant of the Premises or any part thereof without the written consent of the Landlord;
11. The failure of Tenant to execute and return to Landlord or its counsel any subordination agreement required by a Mortgagee within twenty (20) days of Tenant’s receipt of such agreement; or
12. The violation by Tenant of any other of the warranties, representations, terms, conditions, or covenants contained in this Lease, other than the obligation to pay Rental and failure of Tenant to remedy such violation within ten (10) days after written notice thereof is given by Landlord to Tenant.

Acceleration. Upon the occurrence of an Event of Default, the Annual Basic Rental, the Annual Percentage Rental and any Additional Rental provided for in this Lease for the balance of the Term, or any renewal term or other extended term, and all other indebtedness to the Landlord owed by Tenant, shall be and become immediately due and payable at the option of the Landlord and without regard to whether or not possession of the Premises shall have been surrendered to or taken by Landlord. The Annual Percentage Rental for which Tenant remains prospectively liable under the provisions hereof shall be a sum equal to the greatest amount of Annual Percentage Rental paid by Tenant for any Rental Year since the commencement date multiplied by the number of years remaining in the Term at the time of such termination. Tenant agrees to pay Landlord, or an agent on Landlord’s behalf, a reasonable attorney’s fee, as they are incurred, in the event Landlord employs an attorney to collect any rents due hereunder by Tenant, or to protect the interest of Landlord in the event Tenant is adjudged a bankrupt, or legal process is levied upon the goods, furniture, effects or personal property of Tenant upon the Premises, or upon the interest of Tenant in this Lease or in the Premises, or in the event Tenant violates any of the terms, conditions or covenants on the part of Tenant herein contained. In order to further secure the prompt payments of said rents, as and when the same mature, and the faithful performance by Tenant of all and singular terms, conditions and covenants on the part of Tenant herein contained, and all damages and costs that the Landlord may sustain by reason of the violation of said terms, conditions and covenants, or any of them, Tenant hereby expressly waives any and all rights to claim personal property as exempt from levy and sale, under the laws of the State or of any other state in the United States.

Remedies. Upon the occurrence of an Event of Default, Landlord, without notice to Tenant in any instance (except where expressly provided for below) may do any one or more of the following:

1. With or without judicial process, enter the Premises and take possession of any and all goods, inventory, equipment, fixtures and all other personal property of Tenant situated in the Premises without liability for trespass or conversion, and may sell all or any part thereof at public or private sale. Tenant agrees that five (5) days prior notice of any public sale and five (5) days prior notice of the date after which any private sale shall be held shall constitute reasonable notice. The proceeds of any such sale shall be applied, first, to the payment of all costs and expenses of conducting the sale or caring for or storing said property, including all attorney's fees; second, toward the payment of any indebtedness, including (without limitation) indebtedness for Rental, which may be or may become due from Tenant to Landlord; and third, to pay to Tenant, on demand in writing, any surplus remaining after all indebtedness of Tenant to Landlord has been fully paid;

2. Without terminating this Lease, enter upon and take possession of the Premises and expel or remove Tenant and any other person who may be occupying the Premises or any part thereof, make such alterations and repairs as may be necessary in order to re-let the Premises, and re-let the Premises or any part thereof for such term and at such rental and upon such other terms and conditions as Landlord in its sole discretion may deem advisable. Upon each such re-letting, the rentals received by Landlord shall be applied: first, to the payment of any indebtedness other than rent hereunder due from Tenant to Landlord; second, to the payment of any costs and expenses of such re-letting including brokerage fees and attorney's fees and costs of such alterations and repairs; third, to the payment of any rent due and unpaid hereunder, and the residue, if any, shall be held by Landlord and applied in payment of future rent as the same may become due and payable hereunder. If such rentals received from such re-letting during any month shall be less than the rent to be paid during that month by Tenant hereunder, Tenant shall pay any such deficiency to Landlord upon demand. No such re-entry or taking of possession by Landlord shall be construed as an election on its part to terminate this Lease unless a written notice of such intention shall be given to Tenant; and any attempt by Landlord to mitigate its claim for damages against Tenant by re-letting the Premises shall not be construed as a waiver of its right to damages under this section.

3. Perform, on behalf and at the expense of Tenant, any obligation to Landlord under this Lease which Tenant has failed to perform and of which Landlord shall have given Tenant notice, the cost of which performance by Landlord, together with interest thereon at the Default Rate from the date of such expenditure, shall be deemed Additional Rental and shall be payable by Tenant to Landlord upon demand;

4. Elect to terminate this Lease and the tenancy created hereby by giving notice of such election to Tenant, and may reenter the Premises, without the necessity of legal proceedings or process, and may remove Tenant and all other persons (if Tenant is still in possession) and property from the Premises, and may store such property in a public warehouse or elsewhere at the cost of and for the account of Tenant without resort to legal process and without Landlord being deemed guilty of trespass or becoming liable for any loss or damage occasioned thereby; or

5. Exercise any other legal or equitable right or remedy authorized by applicable law.

Damages. If this Lease is terminated by Landlord pursuant, Tenant shall be liable to Landlord for Termination Damages. "Termination Damages" shall mean the aggregate of (a) an amount or amounts equal to the Rental which, but for termination of this Lease, would have become due during the remainder of the Term, less the amount or amounts of Rental, if any, which Landlord shall receive during the remainder of the Term from others to whom the Premises may be rented (other than any Additional Rental received by Landlord as a result of any failure of such person to perform any of its obligations to Landlord) and (b) any damages which may be suffered by Landlord and all reasonable costs, fees and expense including, but not limited to, attorneys fees, costs and expenses, incurred by Landlord in pursuit of its remedies hereunder, or in renting the Premises to others from time to time. Any suit or action brought to collect any such Termination Damages for any month or months shall not in any manner prejudice the right of Landlord to collect any Termination Damages for any subsequent month by a similar proceeding.

If such termination shall take place after the expiration of two (2) or more Rental Years, then, for purposes of computing the Termination Damages, the Annual Percentage Rental payable with respect to each Rental Year following termination (including the Rental Year in which such termination shall take place) shall be equal to the average Annual Percentage Rental payable with respect to each complete Rental Year Preceding termination. If such termination shall take place before the expiration of two (2) Rental Years, then, for purposes of computing Termination Damages, the Annual Percentage Rental payable with respect to each Rental Year following termination (including the Rental Year in which such termination shall take place) shall be conclusively presumed to be equal to twelve (12) times the average monthly payment of Annual Percentage Rental due prior to such termination or if Tenant has not paid any Percentage Rental during this period, then the Annual Basic Rental for each year of the unexpired term shall be a sum equal to twenty-five percent (25%) of the Annual Basic Rental. Termination Damages shall be due and payable immediately upon demand by Landlord following any termination of this Lease. If this Lease is terminated, Landlord may re-let the Premises or any part thereof, alone or together with other premises, for such term or terms (which may be greater or less than the period which otherwise would have constituted the balance of the Term) and on such terms and conditions (which may include concessions or free rent and alterations of the Premises) as Landlord, in its absolute discretion, may determine, but Landlord shall not be liable for, nor shall Tenant's obligations hereunder be diminished by reason of, any failure by Landlord to re-let the Premises or any failure by Landlord to collect any rent due upon such re-letting.

Remedies Cumulative. No reference to any specific right or remedy shall preclude Landlord from exercising any other right or from having any other remedy or from maintaining any action to which it may otherwise be entitled at law or in equity. No failure by Landlord to insist upon the strict performance of any agreement, term, covenant or condition hereof, or to exercise any right or remedy consequent upon a breach thereof, and no acceptance of full or partial rent during the continuance of any such breach, shall constitute a waiver of any such breach, agreement, term, covenant or condition. No waiver by Landlord of any breach by Tenant under this Lease or of any breach by any other Tenant under any other Lease of any portion of the Shopping Center shall affect or alter this Lease in any way whatsoever.

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