



PDF # 1-6

Daoust Vukovich Baker-Sigal Banka LLP
BARRISTERS & SOLICITORS

"KEY PROTECTIONS THE LANDLORD SHOULD OBTAIN WHEN NEGOTIATING EARLY TERMINATION RIGHTS"

By: Jeanne Banka and Joseph Grignano
Commercial Leasing Law & Strategy

PRACTICE STRATEGIES

Key Protections the Landlord Should Obtain When Negotiating Early Termination Rights

By Jeanne Banka and Joseph Grignano

One of the rights that the landlord sometimes has to grant to the tenant is the right to terminate the lease before its natural expiry. This concession may be crucial to securing a desirable tenant or, in other instances, may persuade a reluctant tenant to sign a lease during uncertain economic times.

The exercise of an early termination right is risky to the landlord. It may affect the landlord's highly precious income stream and, in some cases, may also affect the landlord's ability to finance or refinance its property. Accordingly, landlords should be extremely reluctant to grant such rights and should grant the concession only to the strongest of tenants.

If a landlord must grant an early termination right, it is imperative that it seek to obtain various protections, as the failure to do so could prove costly or even disastrous.

Lender Approval

Prior to granting an early termination right, the landlord should thoroughly review its financing agreements in order to ascertain whether lender approval is required. The last

Jeanne Banka is a partner with Daoust Vukovich Baker-Sigal & Banka, L.L.P., in Toronto, Canada. **Joseph Grignano** is an associate with the firm.

Certificates of Insurance

factory to the landlord and meets the requirements established in the lease agreement, there is usually no need for the landlord to require an endorsement to the policy establishing its interest or even to review the underlying policy itself. The ACORD 27 form provides a coverage statement for the benefit of the landlord who is named as either an additional insured or loss payee. This is in stark contrast to the very different state of affairs that exists with respect to the certificate of insurance most widely used for liability insurance.

thing a landlord wants to do is place itself in default of its financing by granting an early termination option without having obtained its lender's consent. If lender approval is required, the grant of the early termination option should be made conditional on obtaining such approval.

Preconditions

- *Personal to Original Tenant.* An early termination right is a huge concession. Presumably, in the context of a shopping center the landlord grants this right in order to secure a tenant that the landlord thought would be beneficial to the whole center. Accordingly, the benefit of an early termination right should not extend to any transferee of the lease, whether an assignee of the original tenant or a share acquirer of the tenant corporation. If all or a majority of the premises have been sublet, the right to terminate early should not apply as there is no real benefit to the prime tenant given that someone else is effectively paying the rent and the prime tenant is not incurring any operating expenses.

- *Tenant Not in Default.* The tenant should be prohibited from exercising its early termination option if it is in default at the time of exercising the option or at any time prior to vacating the premises. However, the landlord should ensure that it has the right to override this requirement as it is sometimes in the landlord's best interests to allow a tenant to end its lease early. By reserving this flexibility, the landlord gets the benefit of having the tenant vacate as well as the protection and benefits that it has (hopefully) negotiated into the early termination provision (such as highly favorable compensation). It is imperative, however, that the lease include language to the effect that the tenant remains required to rectify the default notwithstanding that the landlord has waived the nondefault precondition, in order to avoid arguments based on waiver and estoppel.

Triggering of the Right

A tenant's right to terminate may be triggered by a number of events. Some of the more common triggering events include reaching a set date in the term, the loss of an anchor tenant, the inability to meet gross revenue targets, or the loss or death of a key person. Whatever the triggering event, the landlord should insist that the tenant's right to terminate be exercisable only within a specific time period following the triggering event, so as to avoid granting an open-ended right.

- *Set Date.* It is in the interests of both the landlord and the tenant to stipulate precisely not only the date by which the tenant's written notice of termination must be received by the landlord, but also the date on which actual termination of the lease and vacating of the premises will occur.

- *Loss of Anchor.* Some tenants succeed in having the landlord agree to a termination right (commonly called a "co-tenancy right") which is triggered by the loss of one or more of the shopping center's anchor or key tenants. If the landlord is forced to grant such a right of termination, the landlord should insist that the right not be exercisable if the landlord secures a replacement anchor within a set period of time following the departure of the original anchor tenant. Generally, nine to 12 months is reasonable, but the landlord may wish to increase or decrease the period depending on how long the landlord expects it might take to secure a new anchor.

The landlord should also insist that the right not be exercisable by the tenant unless the tenant experiences a decrease in business below an agreed on level (e.g., a 10 percent decrease in gross sales over the previous year for the same time period). If the termination right is linked to a loss of business, then the landlord should also seek the protections discussed below (see "Inability to Meet Gross Revenue Targets").

- *Inability to Meet Gross Revenue Targets.* Early termination rights linked to a failure on the tenant's part to meet gross revenue targets should include several key protections for the landlord.

Continued on Page 4

Early Termination Rights

Continued from Page 3

First, any such right should require the tenant to make a meaningful attempt to establish its business at the location. The tenant should not be given the ability to terminate after the first or second year of the term, as it is difficult to assess the overall success of a business in the early years. Ideally, the tenant should not be able to terminate until at least the end of the fourth or fifth year of the term. The tenant should be required to verify its gross sales by delivery to the landlord of audited financial statements for the period in question, and the landlord should also secure the right to audit the tenant's sales for that period.

If the lease does not contain an operating covenant, the landlord should include a provision that requires the tenant to operate continuously in the whole of the premises during the relevant gross revenue calculation period. Periods of closure should also be taken into account for the purposes of the gross revenue calculation.

The nontransferability of the tenant's termination right will ensure that a subsequent occupant of the premises is unable to take advantage of its own shortcomings as a retailer by failing to achieve a gross sales threshold that was devised with reference to its predecessor in the premises.

• **Loss of Key Person.** A termination right that is linked to the loss of a key person is often sought by professionals (such as lawyers and dentists) and the operators of owner-managed businesses. If the landlord concedes to this request, it is important that the exit option be linked to the loss of an individual who is vital to the operation of the business and not merely the loss of a supporting staff member. A list of key individuals should be directly incorporated into

the early termination provision in order to avoid future disputes.

The early termination right should only become operative on the death or permanent disability of the key individual, as substantiated by reasonable evidence delivered to the landlord. If the tenant insists that permanent disability is too high a threshold, the landlord may wish to stipulate some length of time during which the key individual must be rendered disabled, the intention being that the tenant should not be able to terminate in the event of a short-term disability. It is also important for the landlord to define disability as a condition that prohibits the key person from materially conducting the business contemplated under the lease. This will avoid situations where the key individual becomes disabled but effectively remains able to carry on or direct his or her duties in respect to the business in the premises.

Payments/Compensation

Giving the tenant an early termination right can be costly and as such, it is important for the landlord to ensure that it is adequately compensated for its losses through the tenant's payment of an early termination fee. At a minimum, the termination fee should reimburse the landlord for the landlord's unamortized costs of leasing the premises to the tenant. These costs include brokerage commissions, tenant inducements, rent concessions, build-out costs, lease takeover costs, premises restoration costs and legal fees.

With respect to brokerage commissions, landlords may wish to consider structuring their brokerage agreements such that the landlord pays a reduced commission in the event that the tenant exercises its early termination option, especially where the tenant refuses to pay an amount on account of brokerage commissions.

Ideally, the early termination fee should also include a lost rent component comprising both base rent and additional rent. The fee should reimburse the landlord for rent lost during the time that the premises were vacant following the tenant's departure. The landlord may wish to consider being reimbursed for the actual period of vacancy as this will ensure that the landlord suffers no

financial loss. In that case, payment may be made on an ongoing basis or as a lump sum, either prior to the tenant vacating the premises or once the premises are re-let. From the tenant's perspective, payment based on actual vacancy effectively ensures that the landlord will not reap a windfall in the event that the landlord is able to immediately re-let the premises.

Most tenants are reluctant to agree to remain responsible for the actual length of the vacancy period as this could subject the tenant to an enormous inestimable expense. Tenants also feel that there is less incentive for the landlord to re-lease the premises (although the landlord could argue that the undesirable appearance of dark space and reduced traffic in the shopping center is more than enough incentive for the landlord to re-let). Accordingly, the landlord may agree on payment of a fixed number of months' rent.

In setting the appropriate number of months, the landlord should take into account the length of the notice period as well as the amount of time that the landlord expects the premises to remain vacant.

Ideally, the landlord should insist on payment of the early termination fee at the time the tenant exercises its option, but may be willing to accept payment at any time prior to the termination date.

Notice Period

If the tenant elects to exercise its termination option, the landlord will want to receive written notice long before the effective date of termination. From the landlord's point of view, a longer notice period affords the landlord more time to find a replacement tenant and keeps the premises occupied for a longer period of time. Generally, the landlord should require at least 12 months' prior notice. However, the notice period may be increased or decreased depending on the size of the premises (larger or anchor tenant premises generally take longer to re-lease) and the historical vacancy period for premises in the shopping center.

As a negotiation tactic, where the tenant is reluctant to agree to a lengthy notice period, the landlord should point out that a longer notice

The publisher of this publication is not engaged in rendering legal, accounting, financial, investment advisory or other professional services. If legal, financial, investment advisory or other professional assistance is required, the services of a competent professional person should be sought.

SURVEY

How States Differ Regarding Enforceability of Oral Agreements for Real Estate Commissions

By Christopher G. Barnes and Suzanne Ilene Schiller

"Trust me." "Let's shake on it." "My word is my bond." These simple phrases can evoke dramatically different reactions among real estate brokers around the country. In one state, such phrases may adequately assure a broker that he or she will be paid a commission, but in another state, they may strike fear in the hearts of brokers.

This article will review the growing differences between states that enforce oral agreements for real estate commissions and those that do not. It will also discuss the various methods used by legislatures to prohibit the enforcement of such agreements, and courts' willingness to follow legislative fiat. (Note that this article is meant only to be a guide to the issues discussed herein, and should not be relied on as a definitive statement of the status of the existing law in any particular jurisdiction.)

Background

At common law, courts interpreted contracts for real estate commissions in precisely the same manner as did any other contract. That is, courts

Early Termination Rights

period helps to reduce the lost rent component of the early termination fee to be paid by the tenant.

Vacating the Premises

The landlord should ensure that the early termination provision includes language that requires the tenant to vacate the premises in accordance with the end of term obligations set out in the lease. However, if the lease exempts the tenant from removing its trade fixtures and/or leasehold improvements, the landlord may wish to consider reinstating the tenant's obligations to make good in the event the tenant exercises its option or, in the alternative, increasing the amount of the termination fee in order to take into account this expense.

The landlord should also ensure that the tenant is responsible for all year-end rent adjustments and that it

determined whether there was (i) an offer to perform real estate brokerage services; (ii) an acceptance of such services; (iii) adequate consideration; and (iv) no defenses to enforcement. As long as a broker could "prove a contract of employment, express or implied, oral or written, between himself and the buyer...or an acceptance and ratification of his acts by the buyer," a broker would be entitled to his commission. See *Axilbund v. McAllister*, 180 A.2d 244 (Pa. 1962). Such was the law in every state until the mid-1870s. Subsequently, the legislators of New Jersey and California became concerned with seemingly unscrupulous claims being made for commissions based on oral agreements. Other states slowly followed suit, and today, over a third of the states restrict the enforceability of oral commission agreements in some manner. See, e.g., *Moran v. Gallo*, 2000 Conn. Super. LEXIS 2552 (Conn. Sup. Ct. 2000); *Eastern Commercial Corp. v. Fusco*, 654 A.2d 833 (Del. 1995); *Ekelman v. Freeman*, 87 N.W.2d 157 (Mich. 1957); *Bruce v. Johnson*, 262 P. 148

provides a post-termination date sales report so that the landlord can calculate percentage rent up to the date of termination. The landlord might also wish to consider denying the tenant the right to receive year-end credits. In this regard, the landlord could point out to the tenant that this was factored into the landlord's decision when it agreed to the early termination fee.

Conclusion

Most of the protections described in this article are a matter of negotiation between a landlord and its tenant. However, landlords should stand firm on most points as the granting of the early termination option is a major concession in and of itself. Incorporating into the early termination provision the various protections outlined in this article will go a long way in reducing the landlord's risk and financial loss.

(Idaho 1927). Today, however, absent a statute or administrative rule explicitly prohibiting such agreements—and occasionally even in spite of such prohibitions—courts steadfastly enforce the oral agreements as long as the broker is able to prove the existence of a contract. See, e.g., *Allred v. Fairchild*, 785 So.2d 1064 (Miss. 2001); *Ormond Park Realty Inc. v. Round Hill Dev. Corp.*, 699 N.Y.S.2d 116 (App. Div. 1999); *Edgar Realty & Assocs. Inc. v. Mobley*, 515 So.2d 1550 (Fla. Ct. App. 1987); *Williams v. Lee*, 493 S.W.2d 122 (Ark. 1973).

Beware of the Administrative Rule

States that have enacted restrictions on commission agreements generally do so in one of three ways: (i) by amending their statute of frauds (by far the most popular method); (ii) by enacting statutes governing the real estate brokerage industry; or (iii) by allowing an administrative body, such as a real estate commission, to implement rules governing the industry. Generally, courts strongly enforce the legislature's restrictions in those states that choose to modify their statute of frauds. On the other hand, courts have been less willing to enforce restrictions created by the other methods.

For example, the New Hampshire Supreme Court has held that an administrative rule requiring written listing agreements would not preclude a broker from collecting a commission where the agreement at issue was oral. See *Finlay Commercial Real Estate Inc. v. Paine*, 573 A.2d 125 (N.H. 1990). Instead, the court ruled that the administrative rule applied only to the internal policies and procedures used by the New Hampshire Real Estate Commission to maintain the integrity of the industry, but did not affect the external, ethical, licensing and disciplinary confines of the business. See also *Marcotte Realty & Auction Inc. v. Schumacher*, 589 P.2d 570 (Kan.

Continued on Page 6

Christopher G. Barnes is an associate at Stevens & Lee, P.C., in Cherry Hill, N.J. **Suzanne Ilene Schiller** is a partner with Spector Gadon & Rosen in Philadelphia.