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Seminar 5

"The Real World": Leases in the Courtroom

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by:

Gregory D. Call, Esq.
Crowell & Moring LLP
275 Battery Street, 23rd Floor
San Francisco, California 91444
gcall@crowell.com

Howard K. Jeruchimowitz, Esq.
Greenberg Traurig, LLP
77 West Wacker, Suite 3100
Chicago, Illinois 60601
jeruchimowitzh@gtlaw.com

At some point, the "perfect" lease that the transactional lawyers negotiated and drafted will be the subject of a litigation and the transactional lawyers will be witnesses. What seems obvious to the parties and lawyers with respect to their unambiguous, iron-clad lease may not be so clear to jurors or judges not regularly involved in real estate deals. Although it is probably more prudent for the parties familiar with the deal to resolve it on their own, there are certain cases that need guidance from the court or where the parties are too emotionally or financially invested that the parties leave it the judge or jury to resolve.

Generally, judges and jurors look for a fair way to resolve disputes.

I. General Ground Rules In Construing Leases

1. Contract Rules Apply

"It is true that shopping centers are, for the most part, a post-World War II development. However, the rules by which we construe documents are ancient and no logical basis for having one set of rules for shopping centers and a different set of rules for other contractual relationships." *Crest Commercial, Inc. v. Union-Hall, Inc.*, 104 Ill.App.2d 110, 118, 243 N.E.2d 652, 657 (1968)

2. The Words Of The Lease Are Critical

"The best evidence of what parties to a written agreement intend is what they say in their writing." *Greenfield v. Philles Records, Inc.*, 98 N.Y.2d 562, 569,750 N.Y.S. 2d 565, 780 N.E.2d 166, 170 (1992). For the most part, if the court or jury can discern the meaning of the provision in lease at issue from the words of the lease, the court will construe this lease based on the four corners of the lease without looking behind the veil at parol evidence. However, if the court cannot discern the meaning of the disputed term, then the court will find the provision ambiguous and look at parol evidence (drafts/negotiations, conduct between the parties, industry custom and practice, past dealings, etc.) to determine the parties' intentions.

3. Common Sense Matters

Courts have also formulated rules of contract interpretation reinforcing the principle that judges should construe contracts in a logical and reasonable manner so that the contract will appear to make sense. A construction of an agreement that defies common sense will almost always be rejected on the grounds that the parties intended to create a logical, rational agreement that works. See, e.g., *Fishman v. LaSalle National Bank*, 247 F. 3d 300, 302 (1st Cir. 2001).

4. Context Matters

The words that the parties chose to employ will also be considered in light of the context in which the parties entered into the contract. *See Restatement (Second) of Contracts* at § 202(1) (1981). A position that is not grounded in a sensible business purpose is likely to be perceived as unreasonable. Judges and jurors also tend to be skeptical of parties who change positions.

5. Who decides?

The judge will decide the meaning of a contract as a question of law. Where appropriate, the judge will give the jury an instruction regarding the meaning of a contract. If the judge determines that the contract is ambiguous and there is conflicting parol evidence, then the jury will resolve the ambiguity regarding the parol evidence.

II. Common Rules Of Construction

When construing and interpreting a lease, the following common rules of construction apply.

1. Objective Intent of the Parties: The essence of contract construction is to ascertain and effectuate the intent of the parties. In so doing, courts will look at objective manifestations of intent rather than the undisclosed, subjective understanding of either party. *See Mellon Bank, N.A. v. Aetna Business Credit, Inc.*, 619 F. 2d 1001, 1009 (3rd Cir. 1980); *Restatement (Second) of Contracts* at § 200(b). Accordingly, what matters in the courtroom is not what either side may

have “thought,” “understood” or “intended” in its own mind during the negotiation of the lease, but what they wrote, said and did.

2. Words Given Usual and Ordinary Meaning: Words that are plain and free from ambiguity must be construed in their usual and ordinary sense. *See Bukuras v. Mueller Group, LLC*, 592 F.3d 255, 262 (1st Cir. 2010). Most often, this means that a court will look to the dictionary meaning of a term.

3. Court Will Not Rewrite Or Remake The Parties’ Agreement: It is not the function of a reviewing court to rewrite or remake the parties’ contract under the guise of contract construction. *See Slatt v. Slatt*, 64 N.Y.2d 966, 967, 488 N.Y.S. 2d 645, 477 N.E.2d 1099, 100 (1985). A court may not, therefore, rewrite a contract to cure an oversight by one party or to achieve by judicial fiat what a party neglected to achieve at the negotiating table.

4. Reasonable, Common Sense Construction: As one Court has succinctly put it, “[c]ommon sense is as much a part of contract interpretation as is the dictionary or the arsenal of cannons." *Fishman v. LaSalle National Bank*, 247 F. 3d 300, 302 (1st Cir. 2001). A court must avoid placing a construction upon a contract which yields a result that is “absurd, commercially unreasonable, or contrary to the reasonable expectations of the parties.” *In re Universal Service Fund Telephone Billing Practice Litigation*, 619 F.3d 1198, 1207 (10th Cir. 2010).

5. The Lease Will Be Construed As A Whole And As A Rational Business Instrument: A court will construe the lease as a whole and not by special emphasis upon any one part in isolation. *See International Klafter Company, Inc. v. Continental Casualty Co., Inc.*, 869 F. 2d 96, 99 (2nd Cir. 1989). The entirety of the lease must also be construed as “a rational business instrument.” *Bank v. International Business Machines Corp.*, 145 F. 3d 420, 430 (1st Cir. 1998).

6. Preference To Give Effect To All Terms And Avoid Surplusage: One part of a contract should not be read to annul another part; the contract should instead be construed, if possible, to give meaning and effect to all of its terms. *Meeting House Lane, Ltd. v. Melso*, 427 Pa. Super 118, 126, 628 A.2d 854,858 (Pa. Super. 1998). Courts are, therefore, more likely to adopt an interpretation that harmonizes all provisions of the lease rather than an interpretation that nullifies one provision in favor of another. *Restatement (Second) of Contracts* at § 203(a).

7. Punctuation And Grammar Matter: Courts routinely look to the use of punctuation and grammar when interpreting contracts. *See, e.g., Deerskin Trading Post v. Spencer Press, Inc.*, 398 Mass. 118, 123, 495 N.E.2d 303, 307 (1986) (under grammatical rules of construction, modifying clause is usually confined to the last antecedent in sentence).

8. Ambiguity Construed Against Draftsperson: It is an axiom of contract interpretation that ambiguity in a contract is construed against the draftsperson. The rule is premised on the notion that the draftsperson often has more bargaining power and is in a better position to protect his interest and avoid creating ambiguity. *Restatement (Second) of Contracts* at § 206. In the context of commercial lease disputes, this rule often means that ambiguity in the landlord’s form of a lease will be construed against the landlord. *See, e.g., Walters v. National Properties, LLC*, 282 Wis.2d 176, 184-85, 699 N.W.2d 71, 75 (2005).

9. More Specific Terms Control Over General Terms: As a rule, specific and exact terms in a contract will be given greater weight than general terms. *Royal Insurance Co. v. Orient Overseas Container Line Ltd.*, 525 F.3d 409, 420 (6th Cir. 2008); *Restatement (Second) of Contracts* at § 203(c).

10. Specifically Negotiated Terms Control Over Standard Terms: Terms of a lease that are specifically negotiated or added during the course of the negotiations will also be given preference over terms in a standard form. *Royal Insurance Co. v. Orient Overseas Container Line Ltd.*, 525 F.3d at 420; *Restatement (Second) of Contracts* at § 203(d).

11. Exceptions And Provisos: The purpose of a proviso (e.g. “for so long as,” or “provided, however,”) or an exception in a lease or other contract is to limit, narrow or restrict the scope of the contractual provision that precedes it. *Chesapeake Energy Corp. v. Bank of New York Mellon Trust Co.*, N. A., 773 F.3d 110, 115 (2nd Cir. 2014). As a result, ambiguity regarding the scope or extent of an exception or proviso will generally be construed against the party seeking to claim

the benefit of the proviso or exception. *See Parker v. Arthur Murray, Inc.*, 10 Ill. App. 3d 1000, 1003, 295 N.E.2d 487, 490 (Ill. App. Ct. 1973).

12. Construction To Avoid Forfeiture: As a general rule, courts will construe contracts to avoid forfeiture, especially on account of a technical or trivial breach. *Fifty States Management Corp. v. Pioneer Auto Parks, Inc.*, 46 N.Y.2d 573, 577, 415 N.Y.S.2d 800, 389 N.E.2d 113 (1979). With respect to commercial leases, this rule has been succinctly formulated as "equity abhors forfeiture of valuable leasehold interests." *Zaid Theatre Corp. v. Sona Realty Co.*, 797 N.Y.S. 2d 434, 436, 18 A.D.3d 352, 355 (2005).

III. Intent Of The Parties

In determining the intent of the parties, the court loos to the following evidence:

1. The Actual Language Used In the Lease

In many cases, the words themselves, viewed in light of the above-described rules of construction, will be dispositive of the issues before the court. This is especially true in those jurisdictions that prohibit a court from examining parol evidence if the lease is not ambiguous. In these situations, courts will typically conclude that they should confine their analysis to the "four corners" of the lease and the circumstances that were attendant to its execution. *See, e.g., Mercury Investment Co. v. F.W. Woolworth Co.*, 1985 OK 38, 706 P.2d 523, 532 (1985) (refusing to imply continuous operating covenant upon tenant based on analysis of the language appearing in the four corners of shopping center lease).

2. Parol Evidence

In those cases in which the court determines that the lease is ambiguous on its face or in those jurisdictions where the court is permitted to examine extrinsic evidence to ascertain whether the lease is ambiguous, courts and juries may consider parol evidence. There are three primary types of parol evidence:

i. evidence of preliminary agreements or drafts exchanged during negotiation of the lease;

ii. evidence of course of performance or course of dealing; and\

iii. evidence of custom or usage in a trade.

See Restatement (Second) of Contracts at §§ 214- 223. Although all three types of evidence may be considered if the parol evidence rule permits resort to extrinsic evidence, the actual language used in the lease is given greater weight than any form of extrinsic evidence. *See Restatement (Second) of Contracts* at §§ 203(b).

IV. "Real World" Cases

Here are some real life examples of what happens when cases are left in the hands of the courts (see attached cases) that will be discussed at the live seminar.

1. General Rules of Lease Interpretation

- *J.C. Penney Co. v. Giant Eagle, Inc.*, 85 F.3d 120 (3d Cir. 1996) – Shopping Center leases interpreted under contract law principles to determine the intent of the parties rather than prior principles of real estate law in interpreting restrictions in leases

- *Crest Commercial, Inc. v. Union-Hall, Inc.*, 104 Ill. App. 3d 110, 243 N.E.2d 652 (1968) – Shopping centers are post-World War II development and same set of rules for lease interpretation for application of restrictive covenant as other contractual relationships.

2. Specific Examples

- *Grand* Prospect *Partners, L.P. v. Ross Dress for Less, Inc.*, 232 Cal. App. 4th 1332, 182 Cal. Rptr. 3d 235 (2015) – full rent abatement for co-tenancy failure is unenforceable penalty

- *Winn-Dixie Stores, Inc. v. Dolgencorp*, LLC, 746 F.3d 1008 (11th Cir. 2014) – application of restrictive covenant for "staple of fancy groceries" and "sales areas" not defined in the lease

- *Kleban* Holding *Co., LLC v. Ann Taylor Retail, Inc.*, 2013 U.S. Dist. LEXIS 168231 (D. Conn. 2013) – rent abatement permanent because Border's out of business

- *Rouse*-Randhurst *Shopping Ctr, v. J.C. Penney Co.*, 171 F. Supp. 2d 824 (N.D. Ill. 2001) – In interpreting leases, operating covenants are at the top of the priorities scale

V. Miscellaneous Overlooked Provisions That Could Impact Litigation

There are several provisions buried at the end of the lease that may impact the litigation that should be negotiated and considered.

1. Jury Trial Waivers: Most jurisdictions allow sophisticated commercial parties to waive their constitutional right to trial by jury so long as the waiver is clear and unambiguous. Assuming the parties agree to waive a jury, the judge will sit as the ultimate finder of fact at trial.

2. Arbitration and Mediation: There is a public policy under state and federal law in favor of arbitration of commercial disputes. Arbitration clauses are, therefore, broadly construed and the arbitrator is generally entitled to determine the scope of his authority. While arbitration is often preferable to litigation, there are many instances where a plaintiff would prefer to have a jury decide the issues rather than an arbitrator. There are also very limited opportunities to appeal an arbitrator's rulings, even if they are legally incorrect.

3. Choice of Law and Choice of Forum: Reasonable choice of law and choice of forum clauses in commercial leases will generally be enforced. Choice of law clauses have the effect of identifying the substantive contract law that will be applied by court. Choice of forum clauses have the effect of specifying the venue and identifying the procedural law that will be applied by the court (e.g., statute of limitations and rules of evidence). Care should be taken if the choice of law provision specifies a different state than the choice of forum provision.

4. Integration and Merger Clauses: These clauses signify that the lease is a complete and integrated agreement and, therefore, parol evidence will not be considered if the lease is not ambiguous.

5. No Oral Modifications: The parties to commercial leases often agree to so-called "private" statute of frauds clauses that oral agreements to modify or amend a lease are not enforceable. These clauses may preclude a party from asserting an argument that the parties orally agreed to modify a lease.

6. Limitations of Liability Provisions: Landlords will generally include clauses in limiting their liability to their equity in the shopping center and insulating parent companies and other affiliated entities from claims for breach of the lease. These clauses may substantially limit a tenant's ability to recover meaningful damages, especially where the center is encumbered by third party debt and is underperforming. These clauses may also limit the landlord's liability to breaches occurring during the period in which the landlord owned the shopping center.

7. Waiver of Consequential Damages: Landlords and tenants often include provisions in a lease waiving their right to recover consequential or punitive damages. In these situations, the opposing party is only entitled to recover its actual direct damages.

8. Anti-Waiver Clauses: These clauses provide that a landlord or a tenants inaction or failure to complain in a specific instance does not preclude the party from enforcing its rights under the lease with respect to future breaches.

9. Disclaimers of Reliance Upon Extracontractual Representations: These clauses often recite that tenant has made its own investigation and has performed its own due diligence before entering into the lease and, as a result, is not relying upon any statement, representation or promise that is

not expressly set forth in the lease. In some jurisdictions these provisions can bar a claim for fraudulent inducement or negligent misrepresentation.

10. Liquidated Damages and Other Remedy Clauses: The parties to commercial leases often specify liquidated damages for certain violations of a lease (e.g., holdover, co-tenancy or operating covenant violations, etc.). Liquidated damages clauses will generally be enforced so long as they do not amount to a penalty. They may also preclude a party from obtaining injunctive and other forms of equitable relief. Exclusive remedy clauses in a lease are also generally enforceable.

11. Estoppel Certificates: Most commercial leases require landlords and tenants to deliver estoppel certificates to lenders and purchasers confirming that the lease is in full force and effect, has not been modified and, in some cases, there are no known defaults. These certificates may operate to bar the signatory from adopting contrary positions in subsequent disputes.

12. Insurance, Indemnity and Waiver of Subrogation Provisions: Commercial leases generally require landlords and tenants to purchase specified types and levels of insurance coverage, in some cases naming the other party as an additional insured. These provisions frequently include mutual waiver of subrogation clauses that prevent the insurer for a party from suing the counterparty to the lease for actions that are covered by required insurance policies.

13. Account Stated Clauses: This clause has the effect of rendering gross sales reports, operating cost reconciliation statements and other statements of account exchanged between the landlord and tenant as conclusive and binding if no objection is made within a specified time period.

14. Notice of Default and Opportunity to Cure: Landlords and tenants usually include provisions in their leases that they will not be in default unless and until they have received a written notice from the other party specifying the nature of the default and giving the recipient the right to cure the same within a set time period.

15. Waiver of Duty to Mitigate Damages: Landlords often include provisions waiving or limiting their obligation to mitigate their damages upon tenant's default by reletting the premises. These clauses are frequently embedded within rent acceleration clauses.