Top Cases and New Laws of 2014 Affecting Leasing and Purchase and Sale Transactions

Los Angeles County Bar Association

Commercial Development and Leasing Subsection

February 26, 2015

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BE CAREFUL WHAT YOU WISH FOR:
ENFORCEABILITY OF CO-TENANCY CLAUSES

Grand Prospect Partners, L.P. v. Ross Dress for Less, Inc.

232 Cal. App. 4th 1332 (2015)

Co-Tenancy Provisions – General Background

- During lease (and letter of intent) negotiations, retailers often argue that their success in a particular center is tied to other retailers operating, generating foot traffic, ensuring a desirable tenant mix, and providing other synergies to the center.

- Co-tenancy provisions typically require that a certain percentage of tenants (or a certain percentage of the floor area of the center) is open and that specifically named tenants (often anchor stores) are open; if the required co-tenants are not open, then the tenant will have certain remedies under the lease.
  - The right to delay opening or to go dark.
  - The right to pay reduced rent.
  - The right to terminate the lease.

The Facts

- Ross signed a lease for approximately 30,000 sf of space in a shopping center in Porterville, California.
- The lease contained a co-tenancy clause:
  - Ross was not required to open its store for business or pay rent (even if Ross opened its store) unless on the commencement date of the Ross lease:
    1. Mervyn's was operating in at least 76,000 sf of floor area in the shopping center;
    2. Target was operating in at least 126,000 sf; and
    3. 70% of the leasable floor area of the shopping center was occupied.
  - If the co-tenancy was not met within 12 months of the Ross commencement date, then Ross would have the right to terminate its lease.
  - Landlord did have the right to replace Mervyn's and Target with other tenants, as long as the replacements occupied the required floor area.
- Mervyn's was not open on the Ross commencement date. Therefore, the co-tenancy wasn't met. As a result, Ross never opened or paid rent and eventually terminated the lease.
- Landlord sued Ross for declaratory relief, breach of contract, and unjust enrichment.

Timeline

- **October 2005** – Landlord and Ross begin negotiating a letter of intent for the premises.
- **July 11, 2007** – Final LOI (including a co-tenancy clause) is signed by the parties.
- **April 8, 2008** – Lease is fully executed.
- **Early July 2008** – Landlord completes its work in the Ross premises (to the tune of $2.3 million).
- **Late July 2008** – Mervyn's files for bankruptcy.
- **October 2008** – Landlord learns that Mervyn's is planning to close its store; Landlord contacts Ross to re-negotiate the lease. Ross proposes amending the lease to require it to open its store (notwithstanding the co-tenancy failure) in exchange for reduced rent, but ultimately the parties cannot reach an agreement.
- **December 31, 2008** – Mervyn's closes its store at the shopping center.
- **February 9, 2009** – Ross takes possession of the premises.
- **May 10, 2009** – Commencement date of the Ross lease.
- **January 2010** – After acquiring title to the Mervyn's property, landlord enters into a lease with Kohl's for 24,000 sf of the Mervyn's space.
- **April 2010** – Landlord sues Ross.
- **May 2010** – Ross terminates the lease.

The Trial Court

- Right before Ross terminated the lease, the landlord sued and argued that the rent abatement clause and the termination clause were either (1) unconscionable or (2) unreasonable penalties, and therefore unenforceable.

- The trial court agreed with the landlord on both theories and awarded the landlord damages of:
  A. $672,100 for the total rent abated (plus interest) during the period from the commencement date until termination,
  plus
  B. $3.1 million in lease termination damages for the 10-year lease,
  plus
  C. over $900,000 in attorneys' fees and costs

  for a total of almost $4.7 million.

- Ross appealed the trial court's decision.

The Appellate Court

Unconscionability. The appellate court reversed the trial court's decision and rejected the landlord's argument that the co-tenancy clause was unconscionable.

- The parties were sophisticated.
- There were extensive negotiations – the parties went through multiple drafts of both the letter of intent and the lease.
- The landlord was under no pressure to enter into the lease.

Procedural and Substantive Unconscionability

The Appellate Court

Unenforceable Penalties. As for the landlord's second theory, that the remedies in the lease (rent abatement and the right to terminate) were unenforceable penalties, the appellate court analyzed the validity of each separately because:

- Ross could abate its rent regardless of whether it subsequently terminated the lease;
- Rent abatement and termination were triggered by different (though partially overlapping) conditions; and
- Rent abatement and termination each result in different consequences to the parties' relationship.

Unenforceable Penalties

Rule: In California, a contractual provision is an unenforceable penalty if the value of the money or property forfeited or transferred bears no reasonable relationship to the range of harm anticipated to be caused by the failure of the provision's requirements.

Unenforceable Penalties

The appellate court pointed out several cases throughout other jurisdictions where courts considered some rent abatement provisions to be enforceable and others to be unenforceable.

- In *Mark-It Place Foods, Inc. v. New Plan Excel Realty Trust* (an Ohio case), a grocery store lease had an exclusive, a violation of which allowed the tenant to abate its rent. When the landlord leased to Wal-Mart in violation of the exclusive, the court ultimately found that the rent abatement was an unenforceable penalty because Wal-Mart could potentially stay in the center for 50+ years thereby allowing the grocery store to remain in the center without paying rent that entire time.

- On the other hand, the rent abatement provision in *Bates Advertising USA, Inc. v. 498 Seventh, LLC* (a New York case) was enforceable. In this case, the rent abatement was tied to the number of days the landlord was delayed in completing landlord's work, and the abatement was different depending on the outstanding item(s) (*i.e.*, half day abatement for one or more less important items, but a whole day abatement for failure to complete a critical item, as outlined on a list included in the lease).

Court's Analysis of the Rent Abatement Clause

- Value of the Property Forfeited. The rent abatement clause allowed Ross to avoid paying $39,500 per month (potentially throughout the entire 10-year term).

- Anticipated Range of Harm. The court concluded that, based on the trial court's findings and the testimony of Ross's executives, the amount of Ross's anticipated harm was ZERO!

No Harm?

- **The Good**: When the landlord initially approached Ross to re-negotiate the terms of the lease after the landlord knew Mervyn's was closing, Ross responded, "We negotiated hard for the Mervyn's co-tenancy because it makes a huge difference to us financially. Without Mervyn's, we will open very soft and it will take much longer for Ross to get established in Porterville."

- **The Bad**: During the trial, Ross executives told a different story, causing the trial court to determine that "Ross did not anticipate any damage, *i.e.*, lost sales or profits, if or because Mervyn's would not be open on the Commencement Date" and that "the presence of Mervyn's was not a condition material to Ross under the Lease . . . ."

- **The Ugly**: Ross did not challenge this finding, and the appellate court noted that such a challenge would have failed anyway, because Ross executives testified during the trial that they did not undertake any study or analysis to determine what impact Mervyn's would have on Ross's potential sales (whether Mervyn's was open or closed). Ross's group vice president of real estate admitted that he was unable to say whether the closure of Mervyn's stores in other shopping centers where Ross was located adversely impacted Ross's sales.

As a result of this testimony, the appellate court determined that Ross did not anticipate any harm to result from Mervyn's closure.

Court's Analysis of the Termination Clause

- The penalty analysis that applied to the rent abatement clause was not applicable to the termination clause.

- The appellate court noted that in California, special rules apply to termination provisions in commercial leases (where there is no forfeiture) – these specific rules will control over the general test used to determine whether a penalty is unenforceable.

- If there is a forfeiture, the court stated it would apply the same "penalty" test it applied to the rent abatement provision. But if not, then the court would apply a different analysis.

- There is no forfeiture when a commercial lease contains a termination clause based upon the occurrence of contingencies that:

  (1) are agreed upon by sophisticated parties; and

  (2) have no relation to any act or default of the parties.

Court's Analysis of the Termination Clause

The court based its analysis of the termination provision on two casualty cases, a 1915 case and a 1999 case, both holding that a termination provision allowing a landlord to terminate the lease after a fire was enforceable.

Court's Analysis of the Termination Clause

The appellate court reversed the trial court's decision on the enforceability of the termination clause – it found Ross's right to terminate the lease was valid and not an unenforceable penalty because:

- The termination clause was based on conditions that were agreed upon by sophisticated parties; and
- The conditions that triggered Ross's right to terminate had no relation to any act or default of the parties, as when the lease was made, neither Ross nor the landlord could control whether Mervyn's continued to operate in the shopping center.

Outcome

Based on the court's analysis, and despite the negotiated lease terms, the rent abatement clause was struck down (meaning Ross owes the landlord the rent that it failed to pay prior to termination ($672,100)), but the termination clause was upheld, allowing Ross to terminate the lease and avoid the lease termination damages ($3.1 million) awarded by the trial court.

RETAILERS' DUTY TO PROVIDE AUTOMATIC EXTERNAL DEFIBRILLATORS

Verdugo v. Target Corporation

327 P.3d 774 (2014)

770 F.3d 1203 (9th Cir. 2014)

Facts

- On August 31, 2008, 49-year-old Mary Ann Verdugo suffered a sudden cardiac arrest while shopping in a Target store in Pico Rivera, California, with her mother and brother.

- Target's employees called 911. The paramedics arrived in several minutes, but ultimately were unable to revive Mary Ann.

- Mary Ann's family sued Target for wrongful death, alleging that Target should have had an Automatic External Defibrillator, or AED, on hand in case of medical emergencies like Mary Ann's, and that Target's failure to have an AED was a substantial cause of Mary Ann's death.

Facts

- The Verdugo family claimed that AEDs should be part of Target's common law obligation to provide reasonable medical care to its customers in the event of an emergency.

- Target agreed that it does have an obligation to provide *some* assistance to a customer who suffers cardiac arrest in one of its stores, but claimed that it fulfilled its obligation in this situation by immediately summoning emergency medical personnel and that it was not required to have an AED available.

Proceedings

- The Verdugo family filed their initial complaint in state court and Target removed the proceeding to federal district court.
- The district court agreed with Target that Target had no duty to provide AEDs and dismissed the case.
- The Verdugos appealed to the Ninth Circuit (arguing that Target had a common law duty to provide AEDs).
- The Ninth Circuit asked the California Supreme Court to decide the question of whether such a common law duty exists in California.

Statutory Requirements

- The California state legislature has mandated that AEDs be available in certain locations (*e.g.*, in health clubs and certain medical facilities).

- However, Health and Safety Code section 1797.196(f) establishes that those statutes should not be interpreted to require building owners or managers to acquire and make available AEDs in their buildings.

- Note: If a business does provide AEDs, Civil Code section 1714.21 grants immunity from civil liability for damages resulting from the use of the AED, but only if the business complies with Health and Safety Code section 1797.196, which contains a substantial number of requirements, including:
  - checking the AED for readiness after every use and at least every 30 days;
  - providing training for at least one employee for every AED unit on hand; and
  - having a trained employee available during operating hours to respond to an emergency.

Holding

- The California Supreme Court determined that Target's common law duty of care owed to its customers does not include the acquisition and use of an AED.
  - In coming to this conclusion, the court looked primarily at two factors:
    1. the foreseeability of a cardiac arrest occurring in a Target store; and
    2. the burden that providing an AED would place on Target.

- They noted that the risk of a cardiac arrest occurring in a Target store is no greater than in any other public location, and that the burden placed on businesses providing AEDs is "more than a minor or minimal burden" based on the numerous obligations imposed by statute.

- The court also noted that having an AED available is not as simple as it seems—it requires proper maintenance, as well as training of store employees on the unit's use.

Future Legislation?

- Although the Ninth Circuit followed the California Supreme Court's guidance and held that there is no common law duty to make AEDs available, Judge Pregerson wrote separately to express his hope that stores like Target will recognize a moral obligation to provide AEDs in the event of an emergency, and added that he thought AEDs should be "as common as first aid kits."
- Judge Pregerson also urged the California legislature to consider implementing a statutory standard of care that would require big box stores to have AEDs on hand.

Other States

Currently, only one state—Oregon—has singled out large retailers (50,000+ square feet) as businesses required to provide AEDs.

ELECTRIC VEHICLE CHARGING STATIONS

New Law for 2015

California Civil Code Section 1952.7

- A new law went into effect on January 1, 2015, in connection with California's policy to promote, encourage, and remove obstacles to the use of electric vehicle (EV) charging stations.

- It gives tenants the right to install EV charging stations on their landlords' property, essentially giving tenants the right to create exclusive parking spaces for themselves—*even if they don't have any parking rights under their leases*.

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California Civil Code Section 1952.7

"**Any term in a lease that is executed, renewed, or extended on or after January 1, 2015, that conveys any possessory interest in commercial property that either prohibits or unreasonably restricts the installation or use of an electric vehicle charging station in a parking space associated with the commercial property, or that is otherwise in conflict with the provisions of this section, is void and unenforceable.**"

- Excluded from compliance with this statute are properties that have:
  - Less than 50 parking spaces total, or
  - At least 2 EV charging station spaces for every 100 parking spaces.
- The statute does not prohibit a landlord from imposing reasonable restrictions on the installation of an EV charging station at the property.

Requirements

Any tenant-installed EV charging station is subject to the following requirements:

- Installation of the EV charging station must comply with all applicable laws (including health and safety standards and zoning, land use, or other ordinances).
- The tenant must maintain liability and property insurance.
- The tenant is responsible for the costs to install, maintain, repair, and replace the EV charging stations.
- The tenant pays for the cost of electricity associated with the EV charging station.

Why Would a Tenant Want to Install an EV Charging Station?

- Given the rise in electric vehicles on the road, tenants may see the installation of EV charging stations as a way to set them apart:
  - Retailers may install EV charging stations to attract customers – who would spend more time in their store while their car charges.
  - Office tenants may find that providing EV charging stations is a valuable perk it can offer its employees.

How Many EV Charging Stations Can a Tenant Install?

- A tenant cannot install an unlimited number of EV charging stations.
  - If under the lease, the tenant is allocated a certain number of parking spaces, then the tenant may only convert those existing parking spaces to EV charging stations.
  - If, however, a lease does not grant the tenant any parking spaces, then the tenant may claim its proportionate share of the property's existing spaces to convert to EV charging stations.

- The landlord may treat any parking space that a tenant converts to an EV charging station as a reserved space and charge a reasonable monthly rent for the space (provided that reserved spaces were not already allotted to tenant under the lease).

Landlord Consent

- A lease can require the landlord's consent before any EV charging station is installed, but the landlord's approval or denial must be in writing and cannot be "willfully avoided or delayed."
  - The landlord must approve of the installation if the tenant complies with the applicable provisions of the lease and agrees to:
    - Comply with landlord's reasonable standards for the installation of the charging station;
    - Engage a licensed contractor to perform the installation; and
    - Provide a certificate of insurance naming the landlord as an additional insured within 14 days of landlord's approval.

Potential Reasonable Restrictions

The statute does not provide examples of what would be considered reasonable restrictions, but here are some ideas to consider:

- Designate specific areas for the EV charging stations.
- Require tenants to install separate electric meters to determine the amount of electricity used by the EV charging station.
- Require tenants to install special signage to identify the EV charging stations.
- Provide one reserved parking space to each tenant.
- Require tenants to provide an additional security deposit for the costs associated with their EV charging station obligations.
- Require tenants to remove the EV charging stations upon lease expiration.

Enforcement

The new law does not explicitly provide statutory enforcement mechanisms or penalties for either party's failure to follow its requirements.

- The only remedy set forth in the law is to render void and unenforceable any specific provisions in a lease that violate the stated requirements.

BROKER DISCLOSURES

New Requirements for 2015

New Disclosure Requirements

- Commercial real estate brokers and agents are now required to disclose whether the broker represents only the buyer/tenant, only the seller/landlord, or both sides of a deal as a dual agent.
- Apply to any purchase and sale transaction, exchange, or lease in any office, industrial, retail, or multi-family property that has a term of more than one year.

Broker	When to Disclose
Listing Broker	Prior to the seller/landlord signing the listing agreement.
Seller’s Broker	To the seller/landlord: Prior to presenting the seller/landlord with an offer to purchase/lease (unless the broker previously provided a copy of the disclosure form as the listing broker).
	To the buyer/tenant: Not later than the next business day after the broker receives the offer from the buyer/tenant.
Buyer’s Broker	Prior to execution of the buyer's/tenant’s offer to purchase/lease.
Dual Agent	The seller/landlord must receive it before the offer is presented and the buyer/tenant must receive the disclosure form prior to signing the offer.
	If during the transaction the broker subsequently assumes the role of dual agent, a new disclosure form must be provided to both parties.

Dual Agents' Responsibilities

Dual agents in commercial transactions are now bound by California Civil Code section 2079.21:

> **"A dual agent shall not disclose to the buyer that the seller is willing to sell the property at a price less than the listing price, without the express written consent of the seller.**
>
> **A dual agent shall not disclose to the seller that the buyer is willing to pay a price greater than the offering price, without the express written consent of the buyer."**

Brokerage Firms

The new disclosure requirement will also apply to the brokerage firm—not just to the individual broker handling the deal.

PHASE I ENVIRONMENTAL REPORTS

New Changes for 2015

Implementation of 2013 Standards in Phase I Environmental Reports

- In 2013, the EPA published new standards governing the process of Phase I Environmental Reports.
- Starting later this year, the 2013 standards will be the only acceptable standards for all Phase I reports. Although not yet required, the industry has already shifted toward using the 2013 standards.
- Buyers should ensure that their Phase I reports are prepared according to the 2013 standards.

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ENERGY EFFICIENCY AND BENCHMARKING

Updates for 2015

Regulations for the Nonresidential Building Energy Use Disclosure Program

As we discussed a couple years ago, commercial building owners in California are required to benchmark and disclose their building's energy use data before selling the building, as well as before financing or leasing the entire building.

Schedule for Compliance

- The law is currently in effect for nonresidential buildings over 10,000 gross square feet, but the California Energy Commission has postponed the scheduled implementation for nonresidential buildings between 5,000 and 10,000 gross square feet until July 1, 2016.

- Required compliance has been delayed in light of the difficulties parties have been facing in attempting to comply with the requirements.