

# Navigating Early Termination Clauses in Commercial Leases

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**T**he COVID-19 pandemic and the Spring 2020 global protests that arose from various US police shootings have affected many people on a deeply personal level. These events have also affected many businesses and commercial landlords, whose leadership and counsel have been forced to make difficult decisions in light of government shutdowns, orders, curfews, and damage to property.

When US states began issuing COVID-19 shutdown orders, starting with Illinois and New Jersey on March 21, 2020, commercial landlords and users found themselves scrambling to better understand their rights, obligations, and remedies under their leases concerning delays caused by circumstances beyond their control. The term “force majeure” found its way into the general lexicon and became a focal point amid unprecedented chaos. In principle, the strength of these force majeure provisions dictated whether a given tenant would be required to continue to pay rent during an event such as a global pandemic. In practice, however, many tenants simply couldn’t—or chose not to—pay their rent, regardless of the requirements under their leases.

Depending on the provisions of their leases, this situation left tenants in the unenviable position of being either automatically in default or being perpetually on the verge of default upon notice from their landlords. In turn, landlords were faced with the choice of pursuing their tenants for outstanding rent (which was made difficult by court closures and certain states’ orders) or allowing them to continue to default in the hopes that their respective states would soon reopen and the economy would quickly recover.

Commercial landlords and tenants were further rocked by a chain of protests and riots that occurred around the globe after George Floyd, a 46-year old Black man, was killed by a police officer in Minneapolis, Minnesota, on May 25, 2020. These events resulted in a significant amount of damage to commercial property and left those landlords and tenants, already struggling to understand and execute their best options and alternatives during a global pandemic, searching other sections of their leases to determine their rights, obligations, and remedies as a result of the damage.

This level of mutual vulnerability concerning a lease is not sustainable long-term for a variety of reasons, including but not limited to the threat to the future creditworthiness of the tenant, the possible existence of personal guarantees, the financial value of the lease, the net operating income of the property, and the property’s resale value. With the foregoing risk in mind, many landlords and tenants have turned their attention away from force majeure and toward either existing termination rights or negotiating settlement agreements that terminate their leases early.

The uncertainty and cost associated with the global events of 2020 highlight the importance of well-

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drafted early termination provisions and the need to anticipate likely and unlikely future calamities. The following is a breakdown of some of the sections included in a typical commercial lease that relate directly to early termination as a result of failures and interruptions due to outside events.

### **Delivery of the Premises**

There are various reasons why a landlord might be unable to give a tenant possession of the leased premises by the agreed-upon date. Often, a delay in the delivery of the premises occurs for reasons that are out of a landlord's control, such as unexpected construction delays (if the landlord is doing the tenant buildout), an existing tenant's failure to vacate the premises timely, or force majeure events. To the extent that a landlord breaches the obligation to timely deliver possession of the leased premises by the specified date—and in the condition defined in the lease—it is typical to expect that a tenant may request an abatement of rent for each day of delay, beneficial occupancy in alternate premises and payment of moving costs, or termination of the lease if delivery of the premises is unlikely to occur within a certain amount of time.

From a landlord's perspective, a tenant's right to terminate a lease if a landlord fails to satisfy the requirements for the delivery of the premises is the last resort, and all other recourses should be considered first. It may be more practical to allow the tenant to occupy temporary alternative space until the substantial completion of the improvements to the premises, assuming there is an adequate vacancy in the building. The tenant may establish a set of detailed parameters and delineate specific standards the alternative premises must meet, such as comparable square footage, data, location within the building or office park, and improvements. Landlords typically agree to these, if possible, and, to ensure the relationship between the parties does not get off to a tumultuous start, also often agree to cover any associated moving and storage costs.

The prospect of a significant delivery delay should lead the parties to determine an outside date by which possession must be delivered before one or both parties may terminate the lease. Because the parties entered into the lease to form a lasting landlord-tenant relationship, the landlord should include in any lease with a tenant-right-to-terminate clause a notice requirement and a resulting cure period during which the landlord must deliver possession of the premises.

### **Assignment and Subletting**

All commercial leases provide for a tenant to extricate itself from a lease, or at the very least, share its liability under the lease through an assignment or a sublease. The landlord will attempt to limit such rights, but ultimately, the parties will try to carve out some flexibility concerning the assignment and subletting provisions in anticipation of unforeseen business needs.

Assignment and subletting provisions provide tenants with an exit strategy when their business needs to change while giving landlords the ability to control the transferability of the lease in most instances. It is imperative to focus on these provisions during lease negotiations, as they are critical to both parties. When drafting these provisions, it is essential to examine the laws of the state in which the property is located because requirements and statutory obligations vary from state to state. Some states have extensive provisions and case law dealing with the topic, but others have very little statutory guidance, leaving the common law of the jurisdiction to govern the issue.

Both subletting and assigning involve the transfer of possession and lease obligations to another party, though there are legal and practical differences between the two. In a sublease, a tenant's right to use and

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possess a portion or all of the premises is transferred to another party for a period that may or may not be coterminous with the term of the master lease. By contrast, an assignment occurs when all of a tenant's rights, interests, and obligations under the lease for the entire premises are transferred to another entity. In a sublease, the original tenant is not released and remains primarily liable to the landlord. An assignment does not guarantee that the original tenant—and any guarantors—will be released from any obligations or liability, so it is not uncommon for the tenant to negotiate its release as part of the assignment process. Assignments are one of the most common methods of terminating a tenant's lease obligations without the tenant having to pay a substantial fee or provide lengthy notice.

The landlord almost always has the right to approve or deny an incoming transferee, regardless of whether the party is a potential assignee or sublessee. The extent of the landlord's power to provide its approval of the transfer is defined by the following terms: reasonable consent, or sole and absolute consent. Under the former, a landlord must reasonably evaluate the incoming tenant and typically uses pre-established criteria. The standard for reasonable consent is generally dictated by the common law and case law of the jurisdiction of the property. Under the reasonableness standard, the burden of establishing the landlord's "unreasonableness" lies entirely on the tenant. For sole and absolute consent, a landlord has the right to deny a prospective tenant without cause.

In leases that feature a reasonable consent standard for transfers, it is prudent to include in the assignment and transfer section a list of the types of information that the tenant must provide the landlord for review and the standards that the landlord will consider in making its determination to consent to or deny the transfer. Such standards usually revolve around the current financial strength of the incoming tenant, the prior financial history, type of business, length of operating history and business reputation, and other business and monetary factors needed to determine the tenant's potential to meet the future obligations arising under the lease. In most cases, the tenant will require that, if the landlord approves the assignment, the tenant and any existing guarantors are released, and all of their obligations under the lease are terminated as of the assignment date.

Other terms that may be negotiated include the tenant's ability to assign or sublet the lease without landlord consent. These typically revolve around the tenant's ability to transfer the lease to a parent, affiliate, or successor entity, or other scenarios giving the tenant the ability to sell and transfer its entire operations without landlord interference. Also, in sublease situations, it is not uncommon to see subtenants asking landlords for non-disturbance agreements requiring the landlord to honor their sublease regardless of whether the original tenant complies with the terms of the lease. Subtenants may also ask the landlord to provide copies of default notices to allow the subtenant to cure the tenant's default.

### **Casualty and Condemnation**

Commercial leases generally include provisions that allow a tenant to terminate the agreement if the premises, the building, or, in some cases, the parking field or entry points to the property are damaged by outside parties or condemned by the government. Casualty termination provisions are typically triggered when there is substantial physical damage to the property that cannot be repaired within a reasonable time.

The biggest issue that arises when drafting casualty provisions is determining a sensible timeline for the restoration obligations. Tenants try to negotiate the shortest timeframe possible so that they can terminate the lease and exert pressure on the landlord to reconstruct. If timely restoration following a casualty is not completed, then the tenant has the right, but not the obligation, to terminate. At the same time, landlords prefer lengthier timeframes to avoid allowing tenants to terminate the lease. When negotiating a timeline

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on behalf of a landlord, it is important to keep in mind that finance companies are less likely to fully finance leases that allow tenants to liberally terminate leases in the event of casualty-related incidents.

Besides establishing the right to terminate, casualty and condemnation provisions may include rent reduction options if the tenant is unable to open after a certain amount of time. Typically, landlords carry rental loss insurance covering any losses related to an existing tenant's failure to pay rent. On the other hand, tenants often carry business interruption insurance, which helps pay for revenue losses and other expenses associated with a business shutting down temporarily. Therefore, it is likely that both tenants and landlords are covered for casualty-related events, but in most cases, tenants request and often obtain an abatement of rent during reconstruction. But when it comes to condemnation, landlords typically receive the full recovery amount provided by the governmental entity. Because the recovery amount is estimated based on the value of the land, it is not a common practice for landlords to share with their tenants any of the condemnation monies recovered. Though tenants are generally allowed to file an independent recovery claim, landlords will prohibit tenants' recovery amount from reducing the landlord's claim or recovery.

### **Negotiated Termination Clauses**

Parties may freely negotiate for an early termination right. Often, the right is requested by the tenant during the negotiation process. In such an event, the tenant is usually required to pay an agreed-upon termination fee to compensate the landlord for the lost term. This amount is generally calculated based on a multiple of months of the rent being paid. Also, parties will generally reach an agreement on whether there will also be reimbursement of any construction allowance payments or unamortized construction expenditures, brokerage fees, and any other concessions. The success of these negotiations generally depends on the bargaining strength of the parties.

Landlords have also been known to request early termination clauses. Retail landlords may request a "kick out" clause during the negotiation of a lease with an untested tenant for fear that the tenant will underperform and drag down the overall performance of a retail center. The termination right gives the landlord the ability to terminate the lease early to replace a tenant that has not met a minimum sales threshold with a tenant the landlord believes will generate more foot traffic and sales for the benefit of the shopping center.

A retail tenant may also ask for such a kick out clause when it is testing out a market and attempting to determine if the location will be profitable. Most of the clauses are based on the tenant meeting a minimum sales threshold during a specified time frame. In either case, the key is establishing a reasonable sales threshold, a reasonable time frame for the tenant to achieve the agreed-upon minimum threshold, and the time frame for the notice required to be given before the early termination of the lease term.

In all cases, the termination time frame should be somewhere around the two-thirds mark of the term. This provides the tenant with sufficient time to prosper and the landlord enough time to evaluate the tenant and have a steady income stream from its initial lease investment. The notice requirement should be structured to give the landlord sufficient time to market the space and attempt to re-let the premises yet not unduly penalize the tenant by requiring the tenant to continue operating an unprofitable location.

The two key additional elements to negotiate, as mentioned above, are the amount of the termination fee required of the tenant and reimbursement of, or recoupment of, construction costs, allowances, and brokerage fees. Generally, if there is agreement on such items, the parties will agree to payment of the unamortized amount of such items based on straight-line depreciation of the same over the life of the full

lease term.

### **COVID-19 and Force Majeure**

As we have all seen, the government-mandated closure of a substantial portion of the business world that it deemed “non-essential” was not something that was contemplated in the context of pre-COVID lease negotiations and was generally left unaddressed in most lease agreements. Likewise, many lease agreements contain language making rent payments an independent covenant, not affected by other lease clauses and, in many cases, specifically carved out of force majeure clauses, compliance with laws clauses, and other lease provisions. The real estate world has been left to its own devices to resolve the issues brought about by the total cessation of income to tenants and landlords alike.

The initial clause that many parties referred to was the force majeure provision, which allows a party to temporarily suspend or delay the performance of its obligations when circumstances beyond its control arise. These circumstances are most commonly defined as “Acts of God,” such as weather events, including tornadoes, hurricanes, and earthquakes, unavailability of materials, civil insurrection, wars, and riots. Pandemics were not usually contemplated or addressed. Also, the clauses generally excuse or delay the time for performance but rarely provide for termination.

The specific language of these clauses is the driving force of their interpretation, and interpretation of these clauses is left to the courts, which have interpreted them strictly in many jurisdictions. Therefore, definitions of force majeure events and what happens when such events occur will be heavily negotiated by both parties in any new leases. The exact wording incorporated under this provision is critical to any lease, especially today as the coronavirus pandemic continues to wreak havoc on commercial leasing. Traditionally, this was considered a “boilerplate” provision that did not receive an overwhelming amount of attention in many cases. This will change in the future as litigation is certain to arise in the current situation.

Parties have already questioned whether the current closures and stay-at-home orders brought on by the pandemic qualify not only as a force majeure event but also as an “impossibility of performance” event under common law. Though it will be a state-specific question, courts have generally been strict in establishing the impossibility of performance as an excuse for performance under a lease and have rarely used impossibility to allow a party to terminate the lease. As a result, expect parties to seek to establish a contractual definition of impossibility in future leases and attempt to establish an outside date after which a termination right can be exercised.

Many real estate attorneys are predicting substantial changes to the way future lease agreements will be drafted and how lenders and prospective buyers will react to them in the property valuation. Tenants may attempt to include a pre-established rent reduction formula in their leases if any of the above clauses are triggered. Some national retailers have already proposed such terminology in the latest drafts of their tenant-friendly form lease agreements. Landlords are expected to reject the addition of such language, as any automatic rent-reduction language is unattractive to lenders and prospective buyers.

A better strategy for landlords may be to take a “wait and see” approach that considers the possibility that future state shutdown orders, like those issued in 2020, may be nuanced rather than universally applicable and may allow certain tenants to continue business operations with to-be-determined health and safety measures in place. Ultimately, the bargaining strength of the parties and the market’s performance will determine whether a given landlord or tenant will achieve the upper hand in these negotiations.

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**Conclusion**

Though it is not unconventional for parties to renegotiate existing terms and conditions throughout the life of a lease, both parties at the outset should anticipate issues that can arise in the future. Although not all future events can be predicted, commercial real estate attorneys are wise to address the unexpected as early as possible in a lease negotiation. This will guarantee that there are plans in place for unforeseen business slowdowns and interruptions and will also provide each party with options and protections to help them overcome these challenges.