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The Rise of the “Good Guy” Guarantee in Commercial Leasing Transactions

In an uncertain market where landlords face the difficult balance between the need to offer favorable leasing terms to prospective tenants while protecting against the growing number of tenants experiencing economic hardship causing them to wind down their businesses, the concept of a “good guy” guarantee has become far more prevalent in leasing transactions, and thus the focus of much more scrutiny and discussion during lease negotiations.

In an effort to protect landlords against a breach by a tenant of its obligations or undertakings in a lease, it is a well-established practice in commercial leasing transactions that a landlord require (i) tenant to post a security deposit (in cash or by letter of credit) and (ii) a principal of tenant (or any other creditworthy affiliate/individual) to guarantee tenant’s performance under the lease. Generally, these guarantees are known as “payment and performance” guarantees in which the guarantor guarantees the payment of all rent and other amounts due by tenant under the lease and the performance of all of tenant’s obligations and undertakings thereunder. While the two aforementioned constructs

protect a landlord against financial losses related to a lease, they fall short in two important areas of concern for landlords. First, neither prevents a tenant from engaging in a drawn-out and costly dispute or litigation during which the tenant may remain in possession of the premises. Second, neither provides a tenant with a true incentive to vacate the space and deliver the premises to landlord as soon as possible after tenant determines that it is no longer practical for it to remain in the space. Thus, the “good guy” guarantee was devised by landlords to motivate tenants to vacate the space and surrender possession of the premises to landlord to avoid arduous and costly landlord-tenant litigation and so that the space may be shown and a new tenant found more easily.

A typical “good guy” guarantee requires one or more of the tenant’s principals (or creditworthy affiliates) to guarantee the rent (and often other payment) obligations under the lease through the date tenant surrenders the leased premises to landlord, even if that occurs prior to the lease expiration date. Usually cast in the form of a “payment and performance” guarantee, the basic “good guy” guarantee contains a specifically negotiated set of limitations or conditions that, if satisfied, releases the guarantor from personal liability thereunder. The basic rationale for such a guarantee is to help satisfy the

landlord’s overriding concern that if the lease is terminated prior to its scheduled expiration as a result of a tenant default, the premises will be surrendered to landlord in the same condition in which they would have been had the lease expired in accordance with its terms (e.g., vacant, broom clean and with all amounts due and owing by tenant paid up to the date of expiration, etc.).

Over the past few years, the nature and scope of the “good guy” guarantee has evolved and the agreement itself has become a much more sophisticated document, with landlords seeking to impose upon guarantors more stringent requirements and restrictions before releasing such guarantors from liability thereunder. Key business terms that require much thought/negotiation include, without limitation:

- **Scope of Liability:** Will guaranteed obligations be limited to payment of fixed rent or will it include additional rent such as operating expenses and taxes? Will guaranteed obligations include performance obligations like repairs, improvements, etc., or other reimbursement obligations of tenant?

- **Condition of the Premises:** Will guaranteed obligations include removal of tenant's property and leasehold improvements?
- **Notice Requirements:** A "good guy" guarantee requires tenant to provide advance notice of surrender (with a range of anywhere from three to 18 or more months) before a guarantor will be released. Landlords generally seek to require as much notice as possible so that they will have ample time to show the space and find a new tenant(s).
- **Security Deposit:** Will the security deposit, if any, held by landlord be applied to offset all of any portion of the guaranteed obligations?
- **Tail/Lump Sum Payment Clause:** Some "good guy" guarantees contain provisions requiring the payment of a negotiated lump sum at the time of surrender.
- **Net Worth/Financial Covenants of Guarantor:** Will the "good guy" nature of guarantee be conditioned upon guarantor maintaining a minimum net worth or satisfying other financial covenants?

Given the complexities of the "good guy" guarantee, we urge both parties to discuss specific terms and conditions early in the "business" discussion stage and preferably prior to the execution of the letter of intent for the lease. Further, as there are a wide range of guarantee structures and a plethora of critical business terms that could have a material effect on landlords, tenants, and guarantors alike, guarantees of any kind in a commercial leasing transaction should always be carefully reviewed by legal counsel before they are signed.

Lease Renewals Must Strictly Follow Lease Terms

In *ADP Statewide Insurance Agencies, Inc. v. Blanchard Securities Co., L.L.C.*, N.J. Super. App. Div. 2011, Docket No. A-2182-09T2, 2011) (Unpublished), the New Jersey Court of Appeals held that a request to extend a lease must strictly comply with the lease's renewal provisions. Pursuant to the express terms and conditions of the lease agreement, the tenant was granted two (2) renewal terms of five (5) years each, provided the tenant delivered notice of its election to exercise the renewal option within a discreet period prior to the end of the current term. After a series of letters and discussions between the landlord and various representatives of the tenant concerning renewal, the tenant vacated the space and stopped paying rent at the end of the initial 10-year lease term.

At issue in the case was whether or not the tenant, in fact, exercised its option to renew the term of the lease. The landlord argued that the tenant had renewed its lease through a series of letters exchanged with the tenant, relying primarily on a letter memorializing a conversation with the tenant about a renewal of the lease. The tenant had signed the letter after the word "Agreed" and then returned it to the landlord. The landlord later sent another letter including a confirmation of the tenant's renewal, which the tenant neither signed nor returned. The tenant, on the other hand, argued that it did not believe such letters renewed the lease because the parties had not discussed any specific terms for a renewed lease.

The Court ruled that the tenant had not renewed its lease because the letters exchanged between the parties did not strictly comply with the specific renewal terms and conditions set forth in the lease. First, the tenant did not deliver

a written notice to the landlord of its final determination to exercise the renewal within the time frame provided in the lease. Second, the letters exchanged between the parties, which the landlord relied on to support his argument, did not contain any specific terms or details for the renewal term, such as the rent.

This case confirms that New Jersey courts will strictly interpret the terms and conditions relating to the exercise of a renewal option in a lease. Therefore, landlords and tenants are advised to carefully comply with the specific terms and conditions in order to properly exercise a renewal option granted under a lease even if prior conduct or correspondence between the parties would suggest otherwise. Further, as there are a wide range of guarantee structures and a plethora of critical business terms that could have a material effect on landlords, tenants, and guarantors alike, when negotiating a lease or communicating in writing with a landlord or a tenant regarding lease renewal options, the lease itself and all correspondence should be carefully reviewed by legal counsel before they are signed and delivered.

Validity of an Election to Extend a Lease Term: Better Late Than Never

In a late 2011 ruling that evidences the equitable powers conferred upon the courts, the Supreme Court, Appellate Division, First Department of New York upheld a trial court decision declaring that a tenant's failure to deliver timely notice to extend the term of its lease was excused on equitable grounds and that the lease renewal notice, although delivered later than required under the lease, was valid.

135 East 57th Street LLC, the plaintiff-appellant and landlord, and Daffy's Inc., the defendant-respondent and

tenant, entered into a lease whose initial term commenced on November 7, 1994, and expired on January 31, 2011. The lease granted Daffy's two options to renew the term for five years each, the first of which was required to be exercised on or before January 31, 2010. Due to its comptroller's administrative error, Daffy's delivered its election to renew the lease on February 4, 2010, via e-mail and facsimile. The landlord rejected Daffy's notice on the grounds that it was late and that it was not delivered in the manner prescribed by the lease. Daffy's subsequently delivered its election letter on February 9, 2010, in accordance with the lease. (The fact that Daffy's February 4 notice was mistakenly dated January 30 did not factor into the Court's decision.)

Two days later, the landlord instituted an action to obtain a declaration that Daffy's had failed to renew the lease in a timely manner, that the renewal option was terminated, and that the lease would expire on January 31, 2011. Daffy's answer to the landlord's complaint sought a declaration that its election to exercise its lease renewal option was valid and effective. The nonjury trial resulted in a decision in favor of Daffy's, entitling it to equitable relief under *J.N.A. Realty Corp. v. Cross Bay Chelsea*, 42 N.Y.2d 392 (1977), in which it was held that, although, as a rule, when a contract requires written notice to be given within a specified time, the notice is ineffective unless it is received within that time, an exception to that rule may be applied on equitable grounds where a forfeiture would result from the tenant's neglect or inadvertence.

The Appellate Division's analysis commenced by describing the standard that equitable relief in the event that a tenant fails to timely exercise a renewal option requires that "(1) the

tenant in good faith made substantial improvements to the premises and would otherwise suffer a forfeiture, (2) the tenant's delay was the result of an excusable default, and (3) the landlord was not prejudiced by the delay." *Vitarelli v. Excel Automotive Tech. Ctr., Inc.*, 25 AD3d 691 (2006). In the instant matter, the Court found that requirements (2) and (3) above were satisfied – the Daffy's comptroller's failure to calendar the timing for delivery of the renewal notice was excusable and the four-day delay in providing the required notice did not prejudice the landlord. However, Daffy's was not able to fulfill the elements of requirement (1) above because the substantial improvements inferred by the trial court occurred too early in the lease term and Daffy's testimony as to improvements was limited to painting and flooring work.

However, the Appellate Division noted that the Court of Appeals, in a case cited in the *J.N.A. Realty* decision, authorized equitable relief against untimely renewal "to preserve the tenant's interest in a 'long-standing location for a retail business' because this is 'an important part of the good will of that enterprise, [and thus] the tenant stands to lose a substantial and valuable asset,'" notwithstanding that no forfeiture of substantial improvements would have occurred. In the instant case, Daffy's introduced evidence that the store in question was popular and successful, creating goodwill, that the company could not identify comparable relocation space after conducting a search and that, even if relocation space was available, it would take close to a year for the new store to open. Based on the loss of goodwill, coupled with the predicted firing of the store's employees, together with Daffy's satisfaction of requirements (2) and (3) above, the Appellate Division

upheld the trial court's decision in favor of Daffy's.

135 East 57th Street LLC v. Daffy's Inc., 2011 NY Slip Op 08497, demonstrates once again the courts' right to invoke equitable remedies. It also makes clear that the loss of goodwill, and not simply the forfeiture of substantial improvements, serves as a basis for granting a tenant equitable relief in the event that the tenant fails to timely deliver its election to renew a lease, and may open the door for tenants to expand the definition of valuable assets that may be forfeited in similar circumstances. Please feel free to reach out to one of the members of our Real Estate Practice Group to discuss the ramifications of this decision as they relate to your transactions.

When Termination Is Not Termination: NY and NJ Bankruptcy Courts' Views on Leases

Given the spate of bankruptcies filed over the last few years, including by large-scale tenants such as Borders, Linens 'n Things, and Circuit City, and the tenuous financial condition of big-box retailers such as Best Buy, it is important for both landlords and tenants to understand the benefits and limitations of bankruptcy protection as it relates to the status of a bankrupt tenant's leasehold interest. It is clear that, when it comes to the issue of lease termination, federal courts sitting in bankruptcy look to state law to determine the property rights in the assets of a bankrupt's estate. Therefore, even as between New York and New Jersey, the rule differs as to when a lease is considered terminated after a monetary default.

"The bright-line rule for bankruptcy courts applying New Jersey law is that the judgment for possession

terminates [a] nonresidential lease, not the issuance of the warrant for removal." *In re Seven Hills*, 403 B.R. 327, 332 (Bankr.D.N.J. 2009) (citing *In re Great Feeling Spas, Inc.*, 275 B.R. 476, 477 (Bankr.D.N.J. 2002); *In re DiCamillo*, 206 B.R. 64, 67 (Bankr.D.N.J. 1997)). However, the New Jersey Anti-Eviction Act provides that a tenant may cure a default in rent payments "at any time on or before the entry of a final judgment." *N.J.S.A. §2A:18-55*. Therefore, even if a commercial lease provides that in the event a tenant defaults thereunder, the landlord may terminate the lease upon a certain number of days' notice, such termination shall not be effective if such tenant files for bankruptcy prior to a final judgment being entered in favor of the landlord. Rather, the lease would be considered a part of the tenant's bankruptcy estate and may be assumed under the Bankruptcy Code. Therefore, as a commercial landlord, it is imperative to pursue judicial remedies as quickly as possible if you seek to terminate a lease prior to a tenant's potential bankruptcy.

Unlike New Jersey, New York state law defers more toward the express terms of the underlying lease. While forfeitures are anathema to New York

courts, "a lease may be terminated under New York State law by operation of a conditional limitation. In this manner, the landlord sends the tenant in default a Notice of Termination of Lease, stating that the lease will be deemed terminated upon a specified date due to tenant's default. The lease is thus terminated upon the mere lapse of time, rather than on any further act by the landlord." *In re Musikahn Corp.*, 57 B.R. 938, 940 (Bankr.E.D.N.Y. 1986) (*citations omitted*). The courts note that any such termination must be implemented in strict accordance with the underlying lease (i.e., all terms and conditions of such termination must be met, the appropriate lease sections referenced, etc.) and differs from leases that provide the landlord with an option to terminate the lease if a default occurs. While the difference in the required wording of the lease may be subtle, it is critical to both a landlord and a tenant because it may be determinative as to whether the bankrupt tenant retains a leasehold interest in the applicable premises or solely an equitable, possessory interest in the premises.

The question then arises as to when a lease is deemed terminated under New York law if the conditional

limitation fact pattern is not applicable. Somewhat similar to New Jersey law, the issuance of a warrant of eviction terminates the landlord-tenant relationship. *In re Sanshoe Worldwide Corp.*, 139 B.R. 585, 594 (Bankr.S.D.N.Y. 1992) (*citations omitted*). However, until that warrant is executed, the tenant retains a possessory interest in the premises (although the landlord-tenant relationship no longer exists) and the automatic stay applies to such interest. *In re P.J. Clarke's Restaurant Corp.*, 265 B.R. 392, 399 (Bankr.S.D.N.Y. 2001) (*citations omitted*). Furthermore, an unexecuted warrant of eviction may be vacated by a court for good cause. *New York RPAPL § 749*.

The brief discussion above serves to highlight the ability of tenants – insolvent or not – to maintain a leasehold interest even after default, regardless of what the lease itself might say. When faced with a situation where you or your tenant are on the verge of bankruptcy, or when considering how to draft a lease to protect your interests in the event of a tenant bankruptcy, please feel free to contact a member of our **Real Estate Practice Group** to discuss the way forward.

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