



R.E.A.C.H.

Real Estate And Construction Highlights

***A Newsletter For Real Estate
and Construction Professionals***

GCA LAW PARTNERS LLP
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Commercial Tenancies in Changing Market Conditions

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THIS ISSUE: Defending or terminating Commercial Tenancies in times of changing market conditions.

FACTUAL SCENARIO: A commercial tenant enters into a 10-year lease during a very competitive market. The tenant pays a premium for the space, a large security deposit, and agrees to covenants in the lease that put all maintenance obligations on the tenant rather than the landlord. Although costly to enter into, and a significant burden on the tenant's finances, the 10-year term in a fully occupied office complex with predictable rent increases offers stability and security against the unknown.

Two years later, there are millions of square feet of unoccupied commercial space, with landlords offering substantial incentives to enter into leases on very favorable terms, often with the landlord paying for tenant

improvements and agreeing to forego rent during the tenant improvement period and even unilateral options to extend granted to tenants.

The tenant wants to terminate the 10-year lease and take advantage of the substantial improvement in market conditions. The tenant hires a savvy lawyer to review the multi-page lease and write to the landlord about the deplorable conditions of the property, the unfair negotiating tactics of the landlord, the unsuitability of the premises for its intended purpose and the landlord's outrageous common area maintenance charges. The tenant's attorney demands that the lease be terminated immediately and the substantial deposit extracted from the tenant be returned. Can the tenant get out of this lease, and if so, at what cost?

This scenario is playing itself out throughout Silicon Valley today. Landlords are receiving these letters virtually every day.

The general rule is that a tenant is stuck with the lease it entered into, though there may be relief available in some limited circumstances.

Binding Contracts: The lease agreement is a binding contract. Although in residential tenancies the landlord cannot extract enormous deposits, demand a waiver of maintenance of the premises, or force the tenant to waive other public policy-related rights, all of those rights may be waived in a commercial tenancy agreement. Though these waivers appear "unfair" later, courts are reluctant to disturb a negotiated agreement of this type.

Changed Conditions: A tenant may allege that conditions have changed so significantly that the premises cannot be used for its intended purpose. "Commercial frustration of purpose" requires that the lease specifically identified the intended use of the premises, that it cannot be used for that purpose under any circumstances, and that the change in conditions was unforeseeable and beyond the tenant's control. This sounds as if it may give a delicatessen owner the right to terminate the lease where the once-full office complex becomes a deserted wasteland. But the "commercial frustration" must

be virtually complete, not merely a reflection of the fact that the tenancy is not as profitable as expected.

Condition of the Premises: By far the most frequently played tenant card is the “condition of the premises” ace. The tenant’s attorney recites the long list of complaints about the premises: “the electricity is frequently interrupted, the water smells bad, the heat/air conditioning is ineffective, the doors and windows are drafty” and the ultimate ace in the hole, “there is mold and mildew and our workers are complaining of respiratory conditions.” A \$10 mold test kit from the hardware store can bolster this claim with “scientific proof.”

In commercial tenancies, there is no implied warranty of habitability or statutory obligation to repair the premises. Repair obligations are a matter of contractual agreement between the landlord and tenant. Modern leases, especially those negotiated in a landlord-friendly market, often assign the entire obligation of maintenance to the tenant. Even without that kind of assignment of obligation, however, California courts have been clear that absent an express contractual obligation a landlord will not be held to any duty of repair.

The unfortunate tenant who writes to the landlord about the deplorable conditions of the premises may well be faced with a demand from the landlord that the tenant must take all steps to correct the conditions and maintain the premises appropriately. Or the landlord might simply take significant and expensive steps to alleviate the “deplorable conditions” and charge those costs against the tenant’s security deposit.

Conclusion: In the scenario above, it is substantially unlikely that a tenant would be able to cost-effectively vacate the premises. But the tenant is not without remedy. He may negotiate with the landlord to pay a sum in exchange for the termination of the lease. If the tenant is already in financial difficulty, a landlord may be willing to take a fixed sum up front rather than risk the tenant defaulting at a later time. But in most situations, where the tenant is simply regretful of the deal he made when the market was more

competitive, the options for termination of the lease without a substantial payment to the landlord (who is holding a large security deposit) are minimal.

But since the contractual provisions of a commercial lease control most situations in a commercial tenancy, a tenant or landlord faced with this situation would do well to have an attorney who understands the intricacies of commercial leases examine the lease for options.

NEXT ISSUE: Issues in construction defect litigation.

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