12 MONTHS

UNLIMITED CLE ACCESS

Empower yourself with unlimited CLE anytime, anywhere for one low price! Choose the subscription package that's right for you:

Subscription Benefits	LawPass Standard	LawPass Premium
Unlimited CLE credits	✓	✓
Access to programs added continuously throughout the year	✓	✓
Upcoming live audio and video webcasts*, and corresponding course materials	✓	✓
The ENTIRE on-demand CLE library available 24/7, and corresponding course materials	✓	✓
On-site attendance at ALL in-person programs		✓
Live streaming of ALL in-person programs		✓
Thousands of legal forms in ALI CLE's online library		✓
All of ALI CLE's online course materials		✓
ONE FULL YEAR	$799.00	$1,999.00

Invest in yourself this year.
Subscribe today at
www.ali-cle.org/LawPass

NOT MUCH MORE THAN THE COST OF JUST ONE IN-PERSON CLE COURSE

*for 1 - 3 hours webcasts

Published by American Law Institute CLE

THE PRACTICAL REAL ESTATE LAWYER

VOLUME 35 | NUMBER 5 | SEPTEMBER 2019

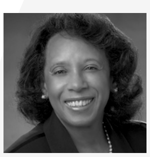
MEET THE EDITORIAL BOARD OF *THE PRACTICAL REAL ESTATE LAWYER*

AMY BRAY is an attorney with Coulter & Sierra, LLC, in Atlanta. She focuses her practice on real estate, encompassing both residential and commercial closings and extensive experience in community association law.

STEVENS A. CAREY is one of the original partners of Pircher, Nichols & Meeks and is co-chair of the firm's continuing education committee. Mr. Carey is in the firm's real estate department and his practice centers on a broad range of transactional real estate matters. He particularly enjoys collaborating with clients to establish procedures and forms that improve efficiency in recurring transactions.

DAVID H. FISHMAN is a former member of the Real Estate Group of Gordon Feinblatt LLC, in Baltimore. He became associated with Gordon Feinblatt in 1964 and served as the Chair of the Real Estate Practice Group for 24 years. He has served as Chairman of the Real Property Section, Maryland State Bar Association, is a member of the American College of Real Estate Lawyers, and has been named in all editions of Best Lawyers in America.

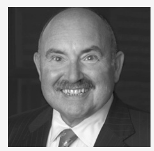
LESLEE LEWIS is a Member of the firm of Dickinson Wright PLLC in Grand Rapids, Michigan. She is counsel to biotechnology, healthcare, manufacturing, industrial, nonprofit, school, professional, hospitality, distribution, retail and development clients in multi-million dollar strategic leasing, development, construction, and real estate acquisition and disposition projects, specifically including green building and leasing projects.



EILEEN D. MILLETT is a Partner in the Real Estate and Environmental Law Practices of Phillips Nizer in New York City. A seasoned environmental lawyer, she advise her clients regarding environmental risks in complex environmental proceedings, including OHSA audits, land use, environmental due diligence, remediation, brownfields, superfund and hazardous waste. She is a Regent of The American College of Environmental Lawyers (ACOEL).

DANNA M. KOZERSKI is a Partner with Coblentz Patch Duffy & Bass LLP, in San Francisco. She represents developers and companies in a wide range of commercial real estate transactions including financing, leasing, and acquisitions and dispositions of office buildings, museums, shopping centers, residential developments and mixed-use projects. She specializes in public/private partnerships and the formation of joint ventures.

JAMES D. PRENDERGAST is a Senior Vice President and the General Counsel of the Uniform Commercial Code Division of First American Title Insurance Company in Santa Ana, California.



MICHAEL RIKON, CRE is a Partner with Goldstein Rikon Rikon & Houghton P.C., in New York City. He is listed in the Who's Who in American Law (3rd to current eds), Who's Who in America, and Who's Who in the World. He is rated "AV" by Martindale-Hubbell. He is designated as a "Super Lawyer" and "Best Lawyer." He is a frequent lecturer on the Law of Eminent Domain. He is the New York State designated eminent domain attorney for Owners' Counsel of America.

MARK SENN is a Partner with Senn Visciano Canges P.C., in Denver. Mark's practice emphasizes all aspects of commercial real estate transactions including preparation and negotiation of leases, purchase and sale contracts, and loan agreements. He represents landlords, tenants, developers, and lenders and frequently serves as an expert witness.

LINDA D. WHITE is a Partner with Dentons LLP, in Chicago. She has a broad based real estate practice and is highly experienced in acquisitions and dispositions, workouts, leasing, financing, joint venture relationships and structuring, development and telecommunications matters. She has played, and continues to play, a leading role in some of the largest real estate transactions in the country.

The Practical Real Estate Lawyer (print ISSN 8756-0372, online ISSN 2640-947X) is published six times a year by American Law Institute Continuing Legal Education. Publication office: 4025 Chestnut Street, Philadelphia, PA. 19104-3099. Publication dates: January, March, May, July, September, November. Subscription rate: $99 a year. Periodicals postage is paid at Philadelphia, PA, and at additional entry office. POSTMASTER: Send address changes to The Practical Real Estate Lawyer, 4025 Chestnut Street, Philadelphia, PA. 19104-3099. Copyright © 2019 by The American Law Institute.

LIQUIDATED DAMAGES IN DELAWARE REAL ESTATE PURCHASE AND SALE AGREEMENTS

ROBERT J. KRAPF is a Director with Richards, Layton & Finger, PA, in Wilmington, Delaware. He is immediate past president of the firm, focuses his practice on a variety of transactional matters in the areas of real estate, commercial, and land use law. His clients include many of the regional and national developers, landlords, banks and other lenders, conservation organizations, institutions, businesses, and industries operating in and from Delaware. Mr. Krapf has held many leadership positions in the state and national bar and has served as a member and officer of the boards of many local, regional, and international business, charitable, and cultural organizations. He is a frequent speaker and author on topics of real estate and land use law.

SARA T. TONER, ESQUIRE is a Director with Richards, Layton & Finger, PA, in Wilmington, Delaware. She is chair of the firm's Real Estate Group. She focuses her practice on complex transactions involving the finance, acquisition, sale, lease, and development of commercial real estate properties. Sara has a particular emphasis on closing sophisticated commercial real estate loans, including CMBS financing, portfolio financing, and mezzanine and preferred equity transactions. She represents major real estate developers, financial institutions, significant holders of commercial real estate, and institutional clients in all types of commercial real estate transactions.

This article is for informational purposes only and is not intended to be and should not be taken as legal advice. In addition, this article is the statement by the authors only and does not necessarily reflect the views of Richards, Layton & Finger, P.A., any of its other attorneys, or its clients. Robert Krapf and Sara Toner are directors and vice-presidents of Richards, Layton & Finger, P.A., in Wilmington, Delaware. The authors are grateful for the assistance of John Fitzgerald, an associate at Richards, Layton & Finger, P.A.

Most contracts for the purchase and sale of commercial real property include among the remedies for breach a provision for the seller to receive or retain the contract deposit as liquidated damages for the purchaser's breach. At times, the contract will also provide for other remedies, whether damages or equitable relief (e.g., specific performance), in addition to the liquidated damages remedy. Including other remedies in the same contract can result in a court having to sort out the extent to which the different remedies are available to the non-breaching party and are not precluded on the basis that other remedies are available.

In particular, courts in various jurisdictions have attempted to address the issue of whether a liquidated damages clause in a contract is invalid because the contract gives the non-breaching party the option to choose between liquidated damages and actual damages. In a recent Colorado case, Ravenstar, LLC v. One Ski Hill Place, LLC,[1] the Colorado Supreme Court held that such an option does not invalidate the liquidated damages provision based on the freedom of the parties to contract as they desire. The court went on, however, to hold that the option is an exclusive one, so the non-breaching party must elect one or the other remedy. Courts of various states are divided on this issue, with the courts in some states finding the liquidated damages provision to be unenforceable on the basis that providing an option of remedies creates a penalty against the breaching party and such a penalty negates the liquidated damages provision.[2] The rationale for that position is that the non-breaching party will choose only liquidated damages if it believes actual damages to be less than liquidated damages, hence the concept of a penalty. On the other hand, courts such as the one in Ravenstar find the election of remedies to be a penalty because a party may not want to engage in litigation to discover what actual damages may be.

There do not appear to be any reported Delaware cases directly on point. The closest reported case appears to be Kysor Indus. Corp. v. Margaux, Inc.,[3] where a letter of intent on a business acquisition provided for a $300,000 termination fee and payment of certain expenses to be paid to the acquirer should the deal not proceed. On summary judgment, the court upheld the termination fee as enforceable liquidated damages. The court denied summary judgment on the claim for expenses because of ambiguity in the expense provision, but not because of an inherent inability to both pursue a damages action for those expenses and to claim the liquidated damages. The court did not find the concept of seeking liquidated damages in addition to actual damages troubling, largely because even if the aggregate of the termination fee together with the claimed expenses were granted to the acquirer, the total damages represented a reasonable percentage of the acquirer's offer.

There are a variety of related issues, however, that have been addressed by the Delaware courts in dealing with the enforceability of liquidated damages clauses and the exclusivity of certain remedies. This article provides a brief overview of these various issues under Delaware law.

May The Seller Choose Specific Performance Instead Of Liquidated Damages (So That Liquidated Damages Are Not An Exclusive Remedy)?

In Delaware, specific performance is not a matter of right, and no party is unconditionally entitled to specific performance.[4] Specific performance is considered by Delaware courts to be "an extraordinary remedy" and thus not readily awarded.[5] The subject matter of the dispute must be that the demanding party: (1) is entitled to specific performance; and (2) has no other adequate remedy at law.[6]

On the first element, entitlement to specific performance, the demanding party must show all of the following: "(1) a valid contract exists, (2) he is ready, willing, and able to perform, and (3) that the balance of equities tips in favor of the party seeking performance."[7] On the second element, Delaware has considered that "[r]eal property is unique; thus, specific performance of a real estate sale contract is often the only adequate remedy … except in rare circumstances."[8]

If the contract is silent concerning specific performance, an aggrieved party still might obtain an award of specific performance, as the Delaware Supreme Court has held that the power to craft an "appropriate remedy for breach of contract is within a court's inherent jurisdiction and is not necessarily confined to the parties' contractual undertakings unless the parties clearly so indicate."[9] Accordingly, specific performance could in principle be awarded notwithstanding a liquidated damages provision if the contract did not expressly disclaim specific performance and if the aggrieved party shows the necessity of such a remedy.[10]

May The Seller Choose Actual Damages Instead Of Liquidated Damages (So That Liquidated Damages Are Not An Exclusive Damage Remedy)?

Delaware courts have held that the aggrieved party is allowed to recover actual damages despite a provision for liquidated damages in the contract.[11] In *Harris v. Conrad*, the plaintiffs had entered into a lease-to-purchase arrangement for a residence. Part of the monthly payments made to the defendant constituted rent and the balance were pre-payments toward the purchase price. Under the terms of the contract, in the event of default by the buyer, the seller could elect to retain the payments made by the buyer either on account of the purchase price or as liquidated damages. If the latter, the contract would be considered terminated. The buyer defaulted in its payments and filed an action for specific performance to recover the "equity" portion of the monthly payments made to the seller that the seller was unwilling to return. The seller counterclaimed for damages suffered by virtue of the plaintiff retaining possession of the property for the period from the intended closing date on the purchase to when plaintiff finally vacated the residence. The court held that although the contract provided for liquidated damages, the seller should be allowed to recover its actual damages in lieu of liquidated damages, though it could not retain the "equity" portion of rents it had received and also recover actual damages for the period the plaintiff remained in possession.[12]

If The Seller May Choose Liquidated Damages Or Actual Damages, May It Have Both?

Delaware courts have generally held that an aggrieved party may have either liquidated or actual damages—but not both.[13] However, Delaware courts have allowed both actual and liquidated damages in two circumstances.[14]

First, actual and liquidated damages may each be available for a different type of breach if the agreement so provides. [15] The court in ISTI Delaware, Inc. v. Townsend noted in dicta that in theory liquidated damages could be recoverable in the event of one type of damage, while actual damages could be recoverable for another type of damage. In this case, however, the court found the contract to be clear: the plaintiff was entitled only to liquidated damages for the buyer's breach, and, under the facts of the case, the plaintiff had no right to claim special or consequential damages for that breach.

Second, a breach due to an event not contemplated by the parties in the liquidated damages clause may allow for the recovery of actual damages, presuming that the contract does not select liquidated damages as the sole remedy.[16] For example, in Delware Limousine Services, Inc. v. Royal Limousine Services, Inc., the court analyzed the scope of the liquidated damages clauses in certain vehicle sublet and sales contracts. Because the contracts at issue did not make liquidated damages the exclusive remedy for all breaches and because the damage suffered by the plaintiff resulted from acts not within the scope of the liquidated damages clause, the plaintiff was entitled to seek actual damages in addition to liquidated damages.

If The Seller May Choose Liquidated Damages Or Actual Damages But Not Both, When Must It Decide?

Delaware courts have not yet directly addressed the question of when an aggrieved party with the right to do so must elect between liquidated and actual damages. In the reported Delaware cases, courts have addressed the parties' choice of relief in the pleadings.[17] Of course, if the aggrieved party terminates the agreement by reason of the other party's breach, the remedy of specific performance is no longer available.[18]

Is There An Applicable Statute Addressing Liquidated Damages Clauses?

No Delaware statute addresses liquidated damages in the sale of real property. Of course, the Delaware Uniform Commercial Code contains a liquidated damages provision for contracts involving the sale of goods.[19] Accordingly, the issues surrounding liquidated damages in the sale of real property are addressed only by case law.

What Is The Test For A Valid Liquidated Damages Clause?

As with a majority of jurisdictions, the general rule for finding an enforceable liquidated damages remedy, as opposed to an unenforceable penalty, is where: (1) the damages that the parties might reasonably anticipate to result from a breach are difficult or impossible to ascertain (at the time of contracting) because of their indefiniteness or uncertainty; and (2) the agreed-upon sum is reasonable.[20] Courts have added that whether liquidated damages are reasonable is determined by whether the damages are either a reasonable estimate of damages that would likely be caused by a breach or reasonably proportionate to what damages have actually been caused by the breach.[21]

Who Has The Burden Of Proof?

As liquidated damages are presumed valid, the party contesting the provision has the burden of proof.[22]

As Of When Is "Reasonableness" Tested?

The "reasonableness" of the liquidated damages amount is tested as of the time of the contract's formation.[23]

What Percentage Of The Purchase Price Is Likely Acceptable As Liquidated Damages?

Delaware courts have not established a bright-line test to determine when damages are too high in proportion to the purchase price, but rather have focused on the circumstances surrounding the parties' adoption of liquidated damages as a remedy under the contract.[24] Moreover, Delaware courts have granted wide latitude to amounts of liquidated damages that were agreed upon by the parties. Liquidated damages provisions may be enforced even though the liquidated damages are "substantially larger than actual damages."[25]

For example, in W&G Seaford Assocs., L.P. v. E. Shore Markets, Inc., the Delaware District Court addressed the issue of whether a landlord could enforce a liquidated damages clause in a commercial lease.[26] In that case, the liquidated damages were triggered by the tenant's failure to open its store in the landlord's center and were equal to the accelerated rent for the entire term of the lease. The court held that this remedy was a liquidated damages provision, not penal in nature, and thus enforceable.[27] In other words, because the parties bargained for liquidated damages as the remedy for this particular breach and agreed upon the amount, the provision was enforceable even though it equaled the entirety of what the landlord might otherwise have received as rent and notwithstanding that the landlord was free to seek actual damages.

Are Actual Damages Relevant For Liquidated Damages, And In Particular, Will Liquidated Damages Be Allowed When There Are No Actual Damages?

Liquidated damages provisions can still be enforced even if there is no proof of actual damages.[28]

IS MITIGATION RELEVANT FOR LIQUIDATED DAMAGES?

Although Delaware law generally requires the damaged party to mitigate its damages,[29] mitigation is not required for liquidated damages to be enforced.[30] This is because liquidated damages are not tied to actual damages, but only to what the parties entering into the contract have agreed to be a reasonable estimate of the damages that could be caused by the breach.[31]

Is A "Shotgun" Liquidated Damages Clause Enforceable?

A so-called "shotgun" liquidated damages clause allows for complete recovery under the contract irrespective of the materiality of the breach. While Delaware has not directly addressed the enforceability of a "shotgun" clause, there exists competing authority on how a Delaware court might consider such a provision.

On one hand, some Delaware cases have considered the enforceability of a liquidated damages provision based on the reasonableness of the damages in relation to what the actual damages are forecasted to be or whether the liquidated damages are reasonably proportionate to the damages actually caused by the breach.[32] At least one Delaware court has held that an agreement to pay a "stipulated sum upon breach, irrespective of the damages sustained, constitutes a penalty…[and] is void as a matter of public policy."[33]

On the other hand, Delaware courts have firmly held parties to their agreement on liquidated damages and broadly considered the parties' intent to justify what may appear to be an inequitable result.[34]

Therefore, a "shotgun" clause could be considered to be in the gray area between a penalty and a valid, contracted-for provision. If parties wish to adopt an enforceable "shotgun" clause in Delaware, they should take care to acknowledge the materiality of the breach allowing the recovery of liquidated damages.

Does A Liquidated Damages Clause Preclude Recovery Of Attorneys' Fees By The Seller?

In instances where a liquidated damages provision specifically contemplates attorneys' fees, Delaware courts have at least not ruled out the enforceability of such a claim in addition to liquidated damages.[35] Even when the liquidated damages provision is silent on the inclusion of attorneys' fees, at least one court has held that courts generally have the power to award attorneys' fees in certain circumstances so long as there is no statute or contract provision to the contrary.[36]

CONCLUSION

Given the importance of freedom of contract under Delaware law,[37] Delaware courts are generally willing to enforce liquidated damages clauses and broadly allow for the remedies that are otherwise available to parties except to the extent the contract has disclaimed or waived the remedy in question.

Notes

1 401 P.3d 552 (Colo. 2017).

2 Williston on Contracts, §§ 65:24 and 4) 65:32th ed. 2002). The courts upholding the provision apparently do so on the basis of freedom of contract.

3 674 A.2d 889 (Del. Super. Ct. 1996).

4 W. Willow-Bay Court, LLC v. Robino-Bay Court Plaza, LLC, 2007 WL 3317551, at *13 (Del. Ch. Nov. 2007 ,2).

5 Osborn ex rel. Osborn v. Kemp, 991 A.2d 1158 ,1153 (Del. 2010).

6 Id.

7 Id.

8 Id. at 63-1162, n.30 (quoting Szambelak v. Tsipouras, 2007 WL 4179315, at *7 (Del. Ch. Nov. 2007 ,19)).

9 Topper v. Topper, 553 A.2d 639 (Del. 1988) (unpublished disposition).

10 See id.

11 1984 WL 21876, at *4 (Del. Ch. Sept. 1984 ,19).

12 Id.

13 Tropical Nursing, Inc. v. Arbors at New Castle Subacute and Rehab. Ctr., 2005 WL 8135148, at *5 (Del. Super. Ct. Apr. 2005 ,4).

14 ISTI Delaware, Inc. v. Townsend, 1993 WL 189467, at *5 (Del. Super. Ct. Mar. 1993 ,31); Delaware Limousine Serv., Inc. v. Royal Limousine Serv., Inc., 1991 WL 53449, at *5 (Del. Super. Ct. Apr. 1991 ,5).

15 ISTI Delaware, Inc., 1993 WL 189467, at *5.

16 Del. Limousine Serv., 1991 WL 53449, at *2.

17 See, e.g., S.H. Deliveries, Inc. v. TriState Courier & Carriage, Inc., 1997 WL 817883, at *2 (Del. Super. Ct. May 1997 ,21) (holding that if an aggrieved party›s liquidated damages are void as they constitute a penalty, then the party›s recovery could be based upon actual damages instead).

18 Draper v. Westwood Dev. Partners, LLC, 2010 WL 2432896, at *5 (Del. Ch. June 2010 ,3); ISTI Delaware, Inc., 1993 WL 189467, at *6.

19 6 Del.C. § 718-2.

20 See, e.g., Lee Builders Inc. v. Wells, 34 Del. Ch. 309 ,307 1954)) (holding that a liquidated damages clause is enforceable when the damages are uncertain and the amount agreed upon is reasonable).

21 Tropical Nursing, Inc. v. Arbors at New Castle Subacute & Rehab. Ctr., 2005 WL 8135148, at *5 (Del. Super. Ct. Apr. ,4 2005); Piccotti›s Rest. v. Gracie›s, Inc., 1988 WL 15338, at *1 (Del. Super. Ct. Feb. 1988 ,23).

22 S.H. Deliveries, Inc., 1997 WL 817883, at *3.

23 Delaware Bay Surgical Servs., P.C. v. Swier, 900 A.2d ,646 651 (Del. 2006); Tropical Nursing, Inc., 2005 WL 8135148, at *5.

24 For example, retention of a %5 down payment fee relating to a purchase of real estate is not considered an unreasonable amount. Lee Builders, Inc., 34 Del. Ch. at 309.

25 S.H. Deliveries, Inc., 1997 WL 817883, at *2.

26 714 F. Supp. 1336 (D. Del. 1989).

27 Id. at 48-1346.

28 Piccotti›s Rest., 1988 WL 15338, at *3 (holding that liquidated damages provisions are valid despite no actual damages being proven).

29 See, e.g., Wise v. W. Union Tel. Co., 181 A. 305 ,302 (Del. Super. Ct. 1935) (noting that injured parties are «under a duty to make a reasonable effort to minimize…damages»); Hanner v. Rice, 2000 WL 303458, at *2 (Del. Super. Ct. Jan. 2000 ,3) («Under the common law of contracts, the measure of damages has always been tempered by the rule requiring the injured party to minimize, that is, mitigate, the losses.»); Wilson v. Pepper, 1995 WL 562235, at *4 (Del. Super. Ct. Aug. 1995 ,21) (noting that «plaintiffs must take steps to mitigate their losses»).

30 Princess Hotels, Int›l Inc. v. Del. State Bar Ass›n, 1997 WL 817853, at *3 (Del. Super. Ct. Oct. 1997 ,29).

31 S.H. Deliveries, Inc., 1997 WL 817883, at *2.

32 See footnote 22.

33 CRS Proppants LLC v. Preferred Resin Holding Co., LLC, 2016 WL 6094167, at *3 (Del. Super. Ct. Sept. 2016 ,27).

34 W&G Seaford Assocs., L.P.,714 F.Supp. at 1348.

35 ISTI Delaware, Inc., 1993 WL 189467, at *6 ,1 (considering but finding no clear-cut answer to the issue of whether liquidated damages provisions preclude the recovery of attorney›s fees and asking the parties to brief the issue).

36 Quinn v. Mitchell, 1989 WL 12178, at *3 (Del. Ch. Feb. ,13 1989).

37 Libeau v. Fox, 880 A.2d 1056 ,1049 (Del. Ch.), judgment entered, (Del. Ch. 2005), aff›d in part, rev›d in part, 892 A.2d 1068 (Del. 2006).

LIQUIDATED DAMAGES IN HAWAII REAL ESTATE PURCHASE AND SALE AGREEMENTS

RAYMOND S. IWAMOTO is a transactional lawyer of Schlack Ito, LLLC, who handles complex real estate and business transactions. He is a Fellow of the prestigious American College of Real Estate Lawyers and served a three year term on its Board of Governors. He is listed in the Best Lawyers in America, Chambers USA America's Leading Lawyers for Business, Superlawyers, and the International Who's Who of Real Estate Lawyers. He was listed in the 14th Edition of Who's Who Legal: Real Estate 2017 as one of the leading real estate practitioners in the United States. He represents local, national and international developers, land owners, financial institutions and individuals engaging in diverse real estate and business acquisitions, development and real estate financing in Hawaii. He has been engaged as an expert witness in real estate litigation. Mr. Iwamoto was born and raised in Honolulu, Hawaii, and graduated from McKinley High School. He is a former U.S. Army Captain, Medical Service Corps., a Vietnam war veteran and a former State Judge Advocate General for the Hawaii Army National Guard.

This article is not intended to provide legal advice. The views expressed (which may vary depending on the context) are not necessarily those of the author, Schlack Ito or ACREL or the Acquisitions Committee. Any errors are those of the author.

Members of the Acquisitions Committee of the American College of Real Estate Lawyers are examining certain questions regarding the topic of "liquidated damages" in their respective jurisdictions. The focus is on commercial real estate contracts and the enforceability of liquidated damage clauses (LDC) in commercial real estate contracts that provide that, in the event of default by the Buyer, the Seller is entitled to retain a liquidated damage amount (LDA), usually the deposit, as liquidated damages. The Hawaii appellate courts have not yet provided answers to many of these questions. These questions are:

1. May the seller choose specific performance instead of liquidated damages (so that liquidated damages are not an exclusive remedy)?
2. May the seller choose actual damages instead of liquidated damages (so that liquidated damages are not an exclusive *damage* remedy)?
3. If the seller may choose liquidated damages or actual damages, may it have both?
4. If the seller may choose liquidated damages or actual damages, but not both, when must it decide?
5. Is there an applicable statute addressing liquidated damages clauses?
6. What is the test for a valid liquidated damages clause?
7. Who has the burden of proof?
8. As of when is "reasonableness" tested?
9. What percentage of the purchase price is likely acceptable as liquidated damages?
10. Are actual damages relevant for liquidated damages and, in particular, will liquidated damages be allowed when there are no actual damages?
11. Is mitigation relevant for liquidated damages?
12. Is a "Shotgun" liquidated damages clause enforceable?
13. Does a liquidated damages clause preclude recovery of attorneys' fees by the seller?

1. May the seller choose specific performance instead of liquidated damages (so that liquidated damages are not an exclusive remedy)?

The case law in Hawaii has not addressed whether a Seller may have an option to choose either liquidated damages or specific performance. The Hawaii courts have not addressed whether specific performance is a remedy that is available to a Seller.

2. May the seller choose actual damages instead of liquidated damages (so that liquidated damages are not an exclusive damage remedy)?

The case law in Hawaii has not addressed whether a Seller may have an option to choose either liquidated damages or actual damages. It may be that so long as the contract did not provide for the LDC to be the exclusive remedy (or even if it did), a Seller may plead alternative remedies such as liquidated damages, actual damages and/or specific performance but, at some point before trial, has to elect one of the alternative remedies. See answer to question 4.

3. If the seller may choose liquidated damages or actual damages, may it have both?

There is no case specifically addressing whether a Seller may elect between liquidated damages or actual damages or whether it may have both. However, in Dias v. Vanek, 67 Haw. 114, 679 P.2d 133 (1984) ("Dias"), the Hawaii Supreme Court cites Hawaii cases on liquidated damages and the principle of reasonable relationship to actual damages, but then goes on to cite cases that hold that the determination of damages is the exclusive province of the jury and orders a retrial because this jury had already been discharged. The opinion says there is nothing in the record to clarify the question of retention or return of the down payment of $20,000 and the damages for breach in the amount of $6,263. Dias, 67 Haw. at 118, 679 P.2d at 136. The Court could have ruled that the Seller should refund the amount of the liquidated amount in excess of the actual damages amount, i.e., $20,000 minus $6,263 or at least some refund. So, we are left to wonder if it's up to the jury to say that or to say that the Seller can retain the $20,000 liquidated amount and the Buyer still has to pay the actual damages amount of $6,263. We have found no other case law that comes any closer in addressing the question whether a Seller may choose between actual damages and either an optional or exclusive LDC or whether the Seller could obtain judgment for both.

In Gomez v. Pagaduan, 1 Haw. App. 70, 613 P.2d 658 (1980) ("Gomez"), an issue was whether the Seller could retain the liquidated damages payment and obtain a judgment for the rental value of the property after the agreement was cancelled. The judgment for rental in addition to the payments made was affirmed without any discussion of the fact that the liquidated damages clause at issue said that the payments made may be retained as liquidated damages *and rent.*

In Kona Hawaiian Associates v. Pacific Group, 680 F. Supp. 1438 (D. Haw. 1988) ("Kona"), a federal district court was faced with an argument that Gomez stood for the proposition that where the amount of the liquidated damages is too low, the provision will not be deemed exclusive. The Court rejected this argument by saying that it was clear in Gomez that the additional damages awarded were not the loss of bargain but for the rental value and were not damages suffered by reason of the Buyer's failure to close. As a federal district court case, this ruling is not binding on the Hawaii state courts.

A recent arbitration involved an LDC. In the arbitration, the Seller demanded the LDA but reserved the right to demand a higher amount if the actual damages were sufficiently in excess of the LDA. Seller's theory was that this meant that the LDA was not a reasonable estimate of actual damages and that therefore actual damages should take precedence. Also, $800,000 of the $1,000,000 deposit had previously been released from escrow and paid to the Seller, and the Buyer argued that the $800,000 should be credited against the $1 million LDA. However, the arbitrator awarded the Seller $1,000,000, ruling that the $800,000 paid was consideration for an extension of time to close. The arbitrator further ruled that in light of actual damages of $19.7 million, $1,000,000 would not be a forfeiture and, citing Shanghai Inv. Co., Inc. v. Alteka Co., Ltd., 92 Hawai'i 482, 993 P.2d 516 (2000) ("Shanghai"), discussed infra, ruled that the LDC was enforceable.

In its Order confirming the Arbitration award in Young Men's Christian Association of Honolulu v. Aloha Kai Development, LLC ("YMCA"), Civ. No. 18-00086 ACK-KSC, 2018 U.S. Dist. LEXIS 94289, (D. Haw. June 5, 2018), the Federal Court ruled that the arbitrator's interpretation of the contract was plausible and within his authority and confirmed the award of damages in the amount of $1,000,000. Then the Court, citing OWBR LLC v. Clear Channel Communications, Inc., 266 F. Supp. 2d 1214 (D. Haw. 2003), ruled that the Seller had to establish that its actual damages were reasonably related to the amount of liquidated damages it was entitled to recover and cited Shanghai for the proposition that liquidated damages must be enforced if there is a reasonable relation between the LDA and the amount of actual damages. YMCA, 2018 U.S. Dist. LEXIS 94289, at *22. Since the YMCA claimed actual damages in the amount of $19.7 million, the $1,000,000 award did not constitute a penalty. The Court then said that the reason the LDA had to have a reasonable relation to the actual damages is because otherwise LDCs would be unenforceable if it functions as a penalty or forfeiture. Id.

4. If the seller may choose liquidated damages or actual damages, but not both, when must it decide?

Once again there is no case law guidance, but in litigation practice, it appears that the trial judge would require the Seller to elect at some point to elect one of the alternative remedies that the Seller had included in his pleadings. If the LDC permits either the LDA or actual damages or is silent as to whether the LDC is the exclusive remedy and if actual damages exceeded the LDA, there would be no incentive for the Seller to choose the LDC as its remedy.

5. Is there an applicable statute addressing liquidated damages clauses?

Hawaii does not have a statute that addresses liquidated damages in transactions involving real estate. However, in connection with the sale of goods, Article 2 of the Uniform Commercial Code (UCC) addresses LDC.

Hawai'i Revised Statutes (HRS) section 490:2-718 provides that damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy.

The UCC provides that its purpose is to clarify the law concerning commercial transactions and therefore addresses liquidated damages in such transactions. HRS § 490:1-103. Thus, a Hawaii court may find the UCC informative in addressing commercial real estate transactions. In Association of Apartment Owners v. Walker-Moody Constr. Co., Ltd., 2 Haw. App. 285, 630 P.2d 652 (1981) ("Walker-Moody"), the Hawaii Intermediate Court of Appeals (the "ICA") said that it preferred to take a consistent and enlightened approach by applying the UCC rule even though the case is not specifically under its coverage. See also Am. Elec. Co., LLC v. Parsons RCI, Inc., 90 F. Supp. 3d 1079, 1084 (D. Haw. 2015) ("Am. Elec."), discussed below.

6. What is the test for a valid liquidated damages clause?

Gomez was the first appellate case to address enforceability of an LDC. Gomez stated that the decision in Jenkins v. Wise, 58 Haw. 592, 574 P.2d 1337 (1978) ("Jenkins") compels its decision and went on to hold that where the Buyer's breach did not involve bad faith conduct, an LDC clause would be enforced by the Seller if there was a reasonable relationship between the amount of payments retained and the amount of Seller's actual damages. Gomez, 1 Haw. App. at 75, 613 P.2d at 661-62. Gomez was followed by Shanghai. In Shanghai, the Hawaii Supreme Court mentioned that the jury found no bad faith breach and stated that under Gomez, the Seller was entitled to retain the deposit if it bore a reasonable relationship to actual damages. Shanghai, 92 Hawai'i at 494-95, 993 P.2d at 528-29. See also Kaiman Realty, Inc. v. Carmichael, 65 Haw. 637, 655 P.2d 872 (1982) ("Kaiman"); Dias, 67 Haw. 114, 679 P.2d 133.

Jenkins was an LDC case only in the sense that the Seller wanted to cancel the agreement and keep the LDA deposit. Since the Court held for the Buyer and ordered specific performance in favor of the Buyer, the enforceability of the LDC was no longer at issue. When the LDC is at issue in a case, we only know what the law is if the Buyer's breach does not involve bad faith.

Thus, case law in Hawaii for the enforceability of an LDC has only addressed situations where the Buyer's breach does not involve gross negligence or bad faith. In Jenkins, the market value had appreciated and the case was about a non-bad faith defaulting Buyer's rights to specific performance. In Gomez, the market value had depreciated and the litigation was over the LDC. Yet the ICA said that the Jenkins principle applies to the Gomez situation. Gomez, 1 Haw. App. at 75, 613 P.2d at 661-62. Gomez then established the law in Hawaii for the enforceability of an LDC where the Buyer's breach does not involve bad faith.

Jenkins was a jury waived case and the trial judge found that the Buyer defaulted the agreement of sale by failing to pay interest and principal when due, and that this warranted cancellation of the agreement. Jenkins, 58 Haw. at 595, 574 P.2d at 1340. However, there were other facts involved that influenced the finding of no bad faith. There is no Hawaii case law to assist us in determining when a Buyer's breach involves bad faith or even to tell us whether the LDC is enforceable where the Buyer's breach does involve bad faith. Even if facts reveal that the Buyer was grossly negligent in failing to close or somehow acted in bad faith in failing to close or refusing to close, it may be that a Seller should still be able to enforce the LDC provided the reasonable relationship test is met. We are also left to wonder if the Buyer's breach did involve bad faith that the Seller could still enforce the LDC even if the reasonable relationship test was not met. Other than dicta in Gomez we have no case authority for the enforceability of an LDC where the Buyer's breach was in bad faith. Gomez suggests that the Seller may be entitled to forfeiture if there had been a bad faith breach. Speaking about the Seller, the ICA said, "He is not, absent purchaser's bad faith, entitled to forfeiture." Gomez, 1 Haw. App. at 75, 613 P.2d at 661-62.

We can say that Hawaii law leaves it to the discretion of the trial judge to answer these uncertainties. In Scotella v. Osgood, 4 Haw. App. 20, 659 P.2d 73 (1983) ("Scotella"), the Buyer's failure to close when required was due to delays by an appraiser and it is likely the Court thought that this breach did not involve bad faith. So, the ICA remanded the case to the trial court to determine the issue of bad faith and whether the Sellers could be adequately compensated for any injury and whether a forfeiture would result, if specific performance was denied. Id. at 25-26, 659 P.2d at 76-77.

In doing so, it stated that the trial court, in exercising its discretion, and applying the reasonable relationship test, could uphold cancellation of the agreement while ordering a refund of that portion of any moneys paid which would constitute a penalty rather than reasonable liquidated damages. Id.

Several of the cases cited in this Article involve installment land sale contract cases, called "agreements of sale" where typically possession and "equitable interests" are transferred to the buyer at an initial closing followed by a subsequent title conveyance closing when the balance owed under the agreement of sale is paid. These include Jenkins, Kaiman, Dias and Gomez. In agreement of sale cases, the Hawaii courts will note that they are akin to financing instruments and that forfeitures include not only the payments made by the buyer but forfeiture of the right of possession and the equitable interest. Other cases cited involve executory contracts where possession as well as title would not yet have passed. These include Shanghai, Scotella and Kona. Despite the different considerations between installment land sale contracts and the ordinary executory contracts, this difference has not been a factor in the cited cases.

7. Who has the burden of proof?

In Hawaii, the party attempting to enforce the liquidated damages clause has the burden of proof to introduce evidence that the LDA bore a reasonable relationship to actual damages. Customarily, the Seller has to put on testimony regarding its actual damages and, as the party enforcing the liquidated damages clause, has the burden of proof of establishing the reasonable relationship between the deposits and the Seller's actual damages.

In Shanghai, the Court noted that, although the Seller had a full and fair opportunity at trial to adduce evidence that the $5 million in damages bore a reasonable relationship to its actual damages, it did not do so. Shanghai, 92 Hawai'i at 495, 993 P.2d at 529.

One wonders if a Seller elects actual damages instead of the LDA under an LDC, the Buyer might raise the LDC as a defense and possibly could have the burden of proof in trying to enforce the LDC.

8. As of when is "reasonableness" tested?

Note that the UCC permits reasonableness to be tested either at the contracting stage or after damages have been incurred.

The UCC's "consistent and enlightened" approach recognizes that there may be difficulties of proof of loss and thus permits a liquidated damages amount that is reasonable in the light of the anticipated harm. HRS § 490:2-718. Thus, the UCC contemplates a prospective look to compare the LDA with anticipated damages.

From the available case law, in the Gomez situation it would appear that under Hawaii law, the reasonableness requirement is to be determined as of trial and a court would not enforce the LDC based purely on a prospective view and would require a retroactive look in testing whether the liquidated damages clause is reasonable and enforceable. Where there are actual damages, the prospective test would appear to be moot because even if it appeared reasonable or unreasonable at the time of contracting, the retrospective look at the actual damages would probably be determinative. However, the following federal cases that apply Hawaii law discusses when reasonableness is to be tested, i.e., both the prospective and retrospective tests. Since Hawaii case law is sparse on the enforceability of LDC, these federal court opinions could be used to argue that it is possible under Hawaii law and under the right circumstances that either test could be used to determine enforceability of a liquidated damages clause.

Clear Channel was a Hawaii federal district court case that was not a purchase and sale case. In that case, the defendant cancelled a hotel conference due to the September 11, 2001 World Trade Center terrorist attacks. 266 F. Supp. 2d at 1216. Instead of a fixed liquidated damages amount, there was a cancellation fee based on a schedule. Id. at 1225. The Court stated correctly that under Hawaii law, liquidated damages must be enforced if there is a reasonable relation between the liquidated damages and the amount of the party's actual damages and that a clause that constituted a penalty would not be enforced. Id. at 1226.

However, the Court also turned to the Restatement (Second) of Contracts § 356 and found that two factors determined whether there was a penalty. The first factor is the reasonableness of the amount in light of the anticipated or actual loss. (Both prospective and retrospective tests.) The second factor is difficulty of proof of loss. The Court stated that the Plaintiff's difficulty in proving its loss weighs in favor of a finding that the liquidated damages clause is enforceable. Id.

This case was a motion for summary judgment case, and due to conflicting evidence of the amount of anticipated and actual damages, the Court determined that there was a genuine issue of material fact and denied the Plaintiff's motion for summary judgment as to the issue of damages with respect to the actual loss part of the first factor of the Restatement (the retrospective reasonableness factor). Id. at 1227. But the Court also granted the Plaintiff's Motion for Summary Judgment as to the issue of damages with respect to the second prong (difficulty of proof of loss). Id. at 1226-27, 1229. This partial denial and partial granting of summary judgment is subject to interpretation. Was satisfying one of the tests sufficient and was this an order for summary judgment upholding the LDC or, since summary judgment on the reasonableness test was denied, did it mean that there would have to be a trial on that issue. The next federal district court case further discusses this issue.

Am. Elec. was a construction delay case providing for liquidated damages for delay. It is instructive in that it provides that even if the parties used the required "buzz" words for the test on a prospective basis, the Court said it will not be divested of its ability to review the reasonableness and enforceability of the clause and the use of terminology such as penalty or liquidated is not determinative. Am. Elec., 90 F. Supp. 3d at 1084. Then the Court actually addressed the question as to whether, under Hawaii law, the test was a prospective or retrospective test or both and even cited to Article 2 of the Uniform Commercial Code. The Court determined that the retrospective actual damages test was only a preferred test and that the Hawaii courts did not foreclose the use of anticipated damages, noting that the prospective test was the majority rule in the United States. Id. at 1088. The Court declared that it would apply both prospective and retrospective tests. Id. at 1089. This prospective test was pertinent in this case because it appeared that there may not have been actual damages as a result of the construction delay but that it was reasonable to have anticipated that there would be. Nevertheless, since this was a Motion for Summary Judgment, the ultimate holding was that there were genuine disputes of material fact precluding summary judgment.

So, if this federal judge accurately described Hawaii law, if the amount of liquidated damages was reasonable at the time of contracting, and if Hawaii law did not "foreclose" the prospective test, and the comparison to actual damages is only a "preferred" test, then it may be that given the right case, a non-defaulting party could recover liquidated damages based on a prospective test even if no actual damages resulted. On the other hand, in a purchase and sale case, if there has been market appreciation and the Seller is retaining a property with a value in excess of the purchase price yet seeks to keep the Buyer's deposits as liquidated damages, it would appear unlikely that a court would enforce the LDC, no matter what the majority rule is in this Country.

Both Clear Channel and Am. Elec. are federal district court cases where proof of actual damages was problematic. As federal district court cases, their interpretation of Hawaii law is not binding. For purposes of this article, which focuses on real estate purchase and sale cases, difficulty in measuring actual damages would be rare as expert testimony could establish fair market value for comparison to the price and the LDA. In all likelihood, if these federal district court cases were to be interpreted that under Hawaii law it would be sufficient to satisfy only the prospective test when actual damages was difficult to determine, they would still not be good precedent for real estate purchase and sale cases. In those cases, the retrospective test looks to be the test to be used. So, even if the LDA is deemed to be a reasonable estimate of anticipated harm, if proven later to be disproportionate to actual damages, the LDC might not be enforced.

Perhaps the parties can contract around the uncertainty as to whether the prospective test alone can determine the enforceability of the LDC. The following is a clause where the second section addresses the prospective/retrospective issue:

The parties agree that, if the Buyer breaches the Contract by failing to perform its obligations by the deadline specified (as the same may be extended as provided herein), the Seller's damages will be difficult to calculate or measure with precision. The parties have made a good faith effort at arriving at a reasonable forecast of the Seller's probable actual damages and have considered the likely impact of any default by Buyer and the various types of damages likely to be incurred. As a result, the parties have agreed on the amount of the Deposit as liquidated damages. The intention of the parties is to approximate the potential actual damages and this sum is not intended as a penalty. In other words, the parties have not agreed on this sum as a disincentive to prevent a breach of contract but instead as a good faith estimate of the actual damages that the Seller is likely to suffer.

The parties further agree, that the market is complex and that the Seller has complex commitments that will be impacted by any default by Buyer and in consideration of all of this, they have agreed on liquidated damages in order to have an efficient remedy in the event of such default without the necessity of having to provide evidence of actual damages or to attempt to prove actual damages and to avoid disputes about direct damages, consequential damages and other such issues. The parties have agreed that the amount of the Deposit bears a reasonable relationship to the parties' reasonable estimate at this time of the damages the Seller is likely to suffer in the event of Buyer's breach and that this reasonableness is to be tested as of the date that the parties enter into this agreement and have agreed that to simplify procedures and to save costs, there is no requirement to examine the actual consequences of any default.

9. What percentage of the purchase price is likely acceptable as liquidated damages?

In real estate purchase and sale transactions, typically at the time of contracting, the LDA is the amount of the deposit with the Seller having the right to keep the deposit as liquidated damages in the event of the Buyer's default. Deposits are usually a small enough percentage of the purchase price to appear to be reasonable. So in a prospective test, the amount could pass muster. However, for the retrospective test, actual damages would typically depend on whether the market price had appreciated or declined.

The following is from a trial level case and illustrates the retrospective test. This was for the sale of several resort condominium units where the deposits totaled $497,000. The actual damages, a 17% drop in market price, plus remarketing expenses and commission added up to $515,450. The Judge ruled that $497,000 bore a reasonable relationship to $515,450 and ruled that the Seller was entitled to keep the deposits as liquidated damages.

Since the determination of "reasonable relationship" is left to the discretion of the trial judge, there will always be a question as to whether you can have a reasonable relationship if the deposits had exceeded the actual damages and whether in the judgment of the trial judge the excess amount would still have a reasonable relationship to the actual damages.

Buyers will expend considerable funds in conducting due diligence and will not agree to limit its remedies in the event of Seller default to termination of the contract. So, the contract will typically provide that Buyers will have all remedies available in law or in equity, including specific performance as well as damages. At times, the parties will cap the damages by agreeing for Seller to pay Buyer's costs subject to a ceiling. There may be contracts where the cap is described as a liquidated damages amount. While there is no case law in Hawaii on such a provision in favor of the Buyer, the same principles will probably apply. The amount might have to bear a reasonable relationship to the Buyer's actual damages.

10. Are Actual Damages Relevant for Liquidated Damages and, in Particular, Will Liquidated Damages Be Allowed When There Are No Actual Damages?

Gomez reviewed *Jenkins* and case law in other jurisdictions and adopted the requirement that there be a reasonable relationship between the LDA and actual damages. 1 Haw. App. at 73-75, 613 P.2d at 661-62. The test of reasonable relationship to actual damages requires evidence of actual damages or loss. The Court in *Shanghai* ruled that the trial court erred in allowing the Seller to retain a five million dollar deposit as liquidated damages because of lack of evidence of actual damages. 92 Hawai'i at 495, 993 P.2d at 529. The record in *Shanghai* did not disclose the fair market value of the property, the actual or estimated costs of resale and other costs, and the Seller failed to present any substantial evidence that the $5 million earnest money deposit bore any relationship to the actual loss. Accordingly, the Court ruled that the trial court erred in allowing the Seller to retain the entire $5 million deposit as liquidated damages.

Whether an LDA bears a reasonable relationship to the amount of actual damages is left to the discretion of the trial judge. An LDA that exceeds actual damages could be enforceable if still viewed as having a reasonable relationship or unenforceable if viewed as a penalty. This leaves open the question as to whether a Hawaii court would enforce an LDC with an LDA couched as a minimum or even as a range of amounts. Would that allow for an award over the minimum or within the range if the amount of actual damages was such that a trial judge can decide that an LDA over the minimum or within the range bears the requisite reasonable relationship?

Therefore, under these cases, liquidated damages will not be allowed when there are no actual damages or when the Seller fails to produce evidence of actual damages. However, as described in section 8 above, since it is not clear under Hawaii law that reasonableness has to be tested only after there are actual damages, if the court were to test reasonableness only against anticipated damages at the time of contracting, liquidated damages could be allowed when there are no actual damages.

11. Is Mitigation Relevant for Liquidated Damages?

Since the test in Hawaii under *Gomez* is to determine the reasonableness of the liquidated damages versus actual damages, actual damages are affected by the need to mitigate. In Hawaii, as elsewhere, the aggrieved party (the Seller) has a duty to make every reasonable effort to mitigate his damages. While not an active mitigation action, in *Clear Channel* there is a discussion of post default revenues received by the Seller which were to be used to offset and calculate the Seller's actual damages. 266 F. Supp. 2d at 1228-29.

In Hawaii, failure to mitigate damages is a defense and the burden would be on the Buyer to prove that mitigation is possible. *Malani v. Clapp*, 56 Haw. 507, 542 P.2d 1265 (1975). In purchase and sale transactions, the obvious mitigation would be to resell the property. There are two potential problems here. First, the resale price may not accurately reflect the value of the property, and second, if the parties are litigating the enforceability of the Seller's rights to keep the deposit, theoretically the Seller's ability to market the property is constrained by the litigation and the Buyer's continuing rights under the contract and mitigation through resale may not be possible until the litigation with the Buyer is concluded.

12. Is a "Shotgun" Liquidated Damages Clause Enforceable?

To have an LDC for any default of any covenant does not appear to be customary in real property purchase and sale agreements, and we have found no Hawaii appellate decision on whether such an LDC would be enforceable.

13. Does a Liquidated Damages Clause Preclude Recovery of Attorneys' Fees by the Seller?

In cases where the liquidated damages clause is upheld, under *Gomez*, it would be upheld because the Court thought the amount had a reasonable relationship to the actual damages and that conceivably the Seller's actual damages would have included his out-of-pocket expenditures such as for legal fees. This probably will depend on the liquidated damages clause in question. It may state that it is the exclusive remedy for all the Seller's damages and this would then include legal fees or it may state that it is the exclusive remedy except for attorney's fees. In *Gomez*, the LDC simply stated that in the event of the purchaser's default, the Sellers may elect to cancel the agreement and all payments theretofore made shall be retained by the Seller and shall be deemed to be liquidated damages and rent for the use and occupation of the property and in settlement of any depreciation of the same and not as a penalty. In footnote 2, the ICA said that the trial court may, if authorized by law, award attorney's fees and costs which were not included in the calculation of actual damages. *Gomez*, 1 Haw. App. at 76 n.2, 613 P.2d at 662 n.2. Hawaii law authorizes the award of attorney's fees in cases concerning assumpsit damages which is defined as for the recovery of damages for non-performance of a contract. *Schulz v. Honsador, Inc.*, 67 Haw. 433, 690 P.2d 279 (1984).

Then too the trial court might consider the type of attorney's fees involved. Attorney's fees incurred in mitigation efforts could be considered part of actual damages but attorney's fees incurred in enforcing the defaulted contract might be considered part of actual damages or might be considered as separate damages.

CONCLUSION

Hawaii case law on liquidated damages is nowhere settled and there are a lot of uncertainties. What we can conclude is that the enforceability of an LDC is left to the discretion of the trial court and if, in its opinion, the amount of the liquidated damages is a penalty, the clause will be unenforceable. It will be enforceable if there is no bad faith breach and if, in the trial court's opinion, the LDA bears a reasonable relationship to the actual damage. The retrospective test and determination of actual damages appear to be required but the prospective test may be applicable in a given case. One wonders whether an LDC is even needed and whether in a contract that provides for a non-refundable deposit, a Seller may plead alternative remedies such as specific performance, actual damages or retention of the deposit and then elect the remedy of retention of the deposit without the necessity of proving the enforceability of a LDC.

As transactional lawyers, we have customarily taken tips from case law throughout the nation in drafting what we would consider required provisions for the liquidated damages clause. These would include statements of anticipated difficulty of measuring actual damages, no intent to penalize, and other such "buzz" words. Sometimes we would negotiate statements of "exclusive remedy". Such drafting and negotiating of the liquidated damages clause is based on anticipating the need to satisfy a prospective test. A federal magistrate reminds us that our efforts may not be as important as we think and that the language used will not prevent the Court from reviewing the enforceability of the clause from a retrospective view and the use of particular words will not be determinative. *Am. Elec.*, 90 F. Supp. 3d at 1084. Furthermore, since, based on the uncertainty created by *Dias*, it may be possible that given the right circumstances, Hawaii law might permit the award of both liquidated and actual damages, or whichever is higher or allow the Seller to have a choice and furthermore, since the trial court will take a retrospective look at the case and apply its discretion, it may be prudent to avoid providing that the liquidated damages clause is the exclusive remedy in lieu of actual damages. All of this creates more negotiating issues as a Buyer's perspective is certainly different. Finally, as noted above, it may be sufficient to provide for a nonrefundable deposit in lieu of an LDC. But until there is more certainty in the case law, Sellers will probably still insist on a liquidated damages clause.

LIQUIDATED DAMAGES IN MARYLAND REAL ESTATE PURCHASE AND SALE AGREEMENTS

KEVIN L. SHEPHERD is a partner with Venable LLP in Baltimore, Maryland and Washington, D.C. His practice covers a broad spectrum of commercial real estate development, with a particular focus on the representation of institutional investors and real estate investment trusts in acquisition/disposition, financing, and leasing. He is a past president of the American College of Real Estate Lawyers, a past chair of the ABA Real Property, Trust and Estate Law Section and the ABA Task Force on Gatekeeper Regulation and the Profession, and is a member of the ABA Board of Governors and is Treasurer-elect of the ABA. The views expressed in this article are those of the author alone.

Maryland appellate courts have addressed liquidated damages in varying contexts for well over a century. In a moment of judicial candor, Maryland's highest court noted that the issue of whether a clause is a valid and enforceable liquidated damages or a penalty "is one of the most difficult and perplexing inquiries encountered in the construction of written agreements." Goldman v. Conn. Gen. Life Ins. Co., 248 A.2d 154, 158 (Md. 1968), quoting Willson v. Mayor and City Council of Baltimore, 34 A. 774, 775 (Md. 1896). This article will discuss the treatment of liquidated damages in real estate purchase and sale agreements by Maryland's appellate courts.

This article is submitted as part of the ongoing project of the American College of Real Estate Lawyers (ACREL) Acquisitions Committee to answer the following 13 questions related to the liquidated damages remedy in commercial purchase and sale agreements under the law of various states. Here are the answers to the questions as discerned through research of Maryland law.

1. May the seller choose specific performance instead of liquidated damages (so that liquidated damages are not an exclusive remedy)?

A real estate purchase and sale agreement may grant a seller the right of specific performance or liquidated damages as alternative remedies. As discussed in the responses to the questions in items 2 and 3 below, if the seller elects the remedy of specific performance as set forth in the agreement, it cannot pursue the remedy of liquidated damages. Under Maryland law, specific performance is an "extraordinary" remedy that may be granted "where more traditional remedies, such as damages, are either unavailable or inadequate." Archway Motors, Inc. v. Herman, 378 A.2d 720, 724 (Md. Ct. Spec. App. 1977). The remedy is appropriate in contracts for the sale of land due to the "uniqueness of land itself, no parcel being exactly like another." Id. Although specific performance is most frequently used as a buyer's remedy in purchase and sale contracts, it is available and even preferred as a seller's remedy. Id. at 724, 725. The party seeking specific performance must "'be able to show that he has fully, not partially, performed everything required to be done on his part.'" Cattail Associates, Inc. v. Sass, 907 A.2d 828, 843 (Md. Ct. Spec. App. 2006) (quoting Clayten v. Proutt, 175 A.2d 757 (Md. 1961)).

2. May the seller choose actual damages instead of liquidated damages (so that liquidated damages are not an exclusive damage remedy)?

A purchase and sale contract may allow a seller to elect, upon a breach by the buyer, either to forfeit the deposit, sue for damages, or seek equitable relief. Casey v. Jones, 339 A.2d 33, 35 (Md. 1975) (if a seller elects a forfeiture of the deposit, it was in the nature of liquidated damages and a seller cannot recover actual damages); Blood v. Gibbons, 418 A.2d 213, 216–17 (Md. 1980) (same).

3. If the seller may choose liquidated damages or actual damages, may it have both?

If a seller receives liquidated damages, Maryland law is clear that the seller may not assert a claim for actual damages. It is "inconsistent" and "therefore not permissible…for a seller of real estate to keep a breaching buyer's deposit and recover actual damages for the breach." Gonsalves v. Bingel, 5 A.3d 768, 778–79 (Md. Ct. Spec. App. 2010) (emphasis in original). See Alois v. Waldman, 149 A.2d 406, 411 (Md. 1959) (one cannot forfeit the deposit as liquidated damages and at the same time make claim for actual damages).

"[U]pon a buyer's breach, one of three remedies may be available to the innocent seller: 1) an action in equity for specific performance; 2) a suit at law for damages based upon breach of contract; and 3) forfeiture of the deposit under an optional forfeiture clause. However, there must be an election of remedies…the injured parties 'cannot be permitted to make the choice between liquidated and actual damages after they have determined which are the greater; for the intent of the option clause is not to give them that advantage, but to make it unnecessary for them to ascertain actual damages.'" Sampson v. McAdoo, 425 A.2d 1, 3 (Md. Ct. Spec. App. 1981) (quoting Sheffield v. Paul T. Stone, Inc., 98 F.2d 250, 252 (D.C. Cir. 1938)). If a plaintiff receives liquidated damages it cannot then make a claim for actual damages.

4. If the seller may choose liquidated damages or actual damages, but not both, when must it decide?

Two cases by Maryland's highest court involved contracts allowing a seller to elect among three remedies, i.e., forfeiture of the deposit, suit for damages, or action for equitable relief. In those cases, the court held that a seller has the right to elect among these remedies so long as notice of the election to pursue a remedy other than forfeiture was given to the buyers within the time specified by the contracts. Casey v. Jones, 339 A.2d 33, 35 (Md. 1975)); Blood v. Gibbons, 418 A.2d 213, 215–17 (Md. 1980). If a contract does not specify a time for making the election, Sampson suggests that the seller must make the election before the determination of damages. Sampson, supra, 425 A.2d at 3 (applying District of Columbia law on forfeitures, but indicating that such law is similar to corresponding Maryland law).

5. Is there an applicable statute addressing liquidated damages clauses?

There is no Maryland statute governing liquidated damages in contracts for the purchase and sale of commercial real estate. There are, however several statutes that deal with liquidated damages in other contexts, all of which are catalogued in Barrie School v. Patch, 933 A.2d 382, 392 n.5 (Md. 2007). See, e.g., the Uniform Commercial Code § 2-718(1) and the corresponding Maryland provision applying to the sale of goods, Md. Code § 2-718(1) of the Commercial Law Article (stating that damages "may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach"), Md. Code § 14-1106(c) of the Commercial Law Article (noting that under Maryland's laws governing layaway sales, the seller may "retain as liquidated damages an amount not to exceed 10 percent of the layaway price or the total amount paid by the buyer to the date of default, whichever is less"), Md. Code § 22-804(a) of the Commercial Law Article (noting that under the Maryland Uniform Computer Information Act, damages for breach of contract may be liquidated by either party in an amount that is reasonable in light of anticipated loss, actual loss, or actual or anticipated difficulties of proving loss in the event of breach), and Md. Code § 10-410(a)(1) of the Courts & Judicial Proceedings Article (noting that any person whose wire, oral, or electronic communications are used in violation of that subtitle is entitled to "[a]ctual damages but not less than liquidated damages computed at the rate of $100 a day for each day of violation or $1,000, whichever is higher").

6. What is the test for a valid liquidated damages clause?

There are three essential elements of a valid and enforceable liquidated damages clause: (a) the clause must provide in clear and unambiguous terms for a certain sum, (b) the liquidated damages must reasonably be compensation for the damages anticipated by the breach, and (c) liquidated damage clauses are by their nature mandatory binding agreements before the fact that may not be altered to correspond to actual damages determined after the fact. Massachusetts Indemnity and Life Ins. Co. v. Dresser, 306 A.2d 213, 216 (Md. 1973). According to a case decided over thirty years later, Maryland's highest court repeated the three "essential elements" but then went on to state that the "decisive element" is the intention of the parties—whether the parties intended that the sum be a penalty or an agreed-upon amount as damages in case of a breach. Such intent is to be gleaned from the subject matter, the language of the contract, and the circumstances surrounding its execution. Board of Education v. Heister, 896 A.2d 342, 351 (Md. 2006).

For over a century, Maryland courts have held that the amount named in an agreement as the sum to be paid as liquidated damages will be regarded as liquidated damages and not as a penalty, unless the amount so agreed upon and inserted in the agreement is grossly excessive and out of all proportion to the damages that might reasonably have been expected to result from such breach of the contract. The issue of whether the amount is excessive or whether the damages are incapable of exact ascertainment should be determined from the subject-matter of the contract considered in the light of all the surrounding facts and circumstances connected therewith and known to the parties at the time of its execution. Balto. Bridge Co. v. U. Rwys. & E. Co., 93 A. 420, 422–23 (Md. 1915).

An early Maryland case distinguished between a deposit made as part of the purchase price in real estate contracts and deposits made in connection with non-real estate contracts. Willson v. Mayor and City Council of Baltimore, 34 A. 774, 776–77 (Md. 1896). According to the Willson court, a deposit made on the purchase of land should always be treated as liquidated damages and not as a penalty because it is given as part performance of the buyer's obligations, whereas a deposit made in connection with a lease or service contract is "not a part of the thing to be done under or in execution of the contract, but is required simply and solely as a condition precedent to entering into the contract…." Id. at 777. The court explained that a deposit made in connection with a contract not involving the sale of real estate is "collateral to the contract and a mere guaranty that its provisions will be observed…." Id. Willson established this bright-line rule because declining to do so would "introduce a sweeping departure from established principles.…[and would] ignore or arbitrarily override all other principles of interpretation[.]" Id. Subsequent Maryland cases have not embraced this doctrinaire approach in drawing a bright-line distinction between real estate and non-real estate contracts in determining whether deposits should be considered liquidated damages or a penalty.

7. Who has the burden of proof?

The breaching party has the burden of proof. Barrie School v. Patch, 933 A.2d 382, 388 (Md. 2007) (citing Dashiell v. Meeks, 913 A.2d 10, 20 (Md. 2006)) (placing the burden of proof on the challenger is consistent with giving the non-breaching party the advantage inherent in stipulated damages clauses, that of eliminating the need to prove damages, and with the general principle of Maryland law that assumes that bargains are enforceable and that the party asking the court to invalidate a bargain should demonstrate the justice of that party's view).

8. As of when is "reasonableness" tested?

Absent specific statutory provisions, the time of contract formation is the appropriate point from which to judge the reasonableness of a liquidated damages provision. Barrie School v. Patch, 933 A.2d 382, 389 (Md. 2007). Examples of these specific statutory provisions, which do not deal with liquidated damages in contracts for the purchase and sale of commercial real estate, include UCC § 2-718(1) and the corresponding Maryland provision applying to the sale of goods, Md. Comm. Law Article § 2-718(1) (stating that damages "may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach").

9. What percentage of the purchase price is likely acceptable as liquidated damages?

Where liquidated damages accumulate over a period of time, those damages may be limited by the court to whatever time is reasonably necessary to comply with contractual demands or, more specifically to complete the work by a substitute contractor or by the non-breaching party's own efforts. Cuesport Properties, LLC v. Critical Developments, LLC, 61 A.3d 91 (Md. Ct. Spec. App. 2006) (court upheld $126 per day for liquidated damages that accrued over a period of 260 days, which period began on the contractual deadline for completing a wall and the date on which the modifications to the wall were completed); see Alois v. Waldman, 149 A.2d 406, 411 (Md. 1959) (forfeiture of deposit equal to 10% of the purchase price would be enforceable as liquidated damages); see also Goldman v. Connecticut General Life Ins. Co., 248 A.2d 154, 158 (Md. 1968) (1% commitment fee is not liquidated damages; rather, it is consideration paid for the lender's undertaking to perform; commitment made no mention of "liquidated damages"); cf. Greentree Series V, Inc. v. Hofmeister, 114 A.3d 230, 238 (Md. Ct. Spec. App. 2015) (newspaper ad calling for forfeiture of a deposit in a foreclosure sale, under the facts of this case, constitutes a penalty and is unenforceable as a valid liquidated damages clause).

Generally, when the buyer in a purchase and sale contract fails to satisfy a condition to closing, the buyer may forfeit its deposit. Bushmiller v. Schiller, 368 A.2d 1044, 1045, 1049 (Md. Ct. Spec. App. 1977) (holding that the defaulting buyer of a residential property was not entitled to a return of her deposit, which was 10% of the purchase price).

10. Are actual damages relevant for liquidated damages and, in particular, will liquidated damages be allowed when there are no actual damages?

Actual damages are not taken into account in determining the validity of liquidated damages. "[O]nce the court has completed its inquiry and determined that the liquidated damages clause is valid and enforceable, 'it need not make further inquiries as the actual damages.'" CAS Severn, Inc. v. Awalt, 75 A.3d 382 (Md. Ct. Spec. App. 2013), (quoting Barrie School v. Patch, 933 A.2d 382, 392 (Md. 2007)). Maryland's highest court has explained that actual damages may be more or less than those anticipated at the time of parties entered into the contract:

If more, this fact would not characterize or stamp the stipulation as a penalty unless it was so exorbitant as to clearly show that such amount was not arrived at in a bona fide effort, made at or before the execution of the contract, to estimate the damages that might have been reasonably expected to result from a breach of it, and that it was named as a penalty for such breach, And, on the other hand, if the amount stipulated was found to be inadequate, a greater amount could not be recovered for such breach, because the agreement between the parties that the amount so named should be in lieu of the damages resulting therefrom.

Balto. Bridge Co. v. U. Rwys. & E. Co., 93 A. 420, 422–23 (Md. 1915).

11. Is mitigation relevant for liquidated damages?

There is no obligation to mitigate damages in case of a liquidated damages provision. According to Maryland's highest court, the liquidated damages clause would be "blunted" if the non-breaching party had to mitigate its damages. Barrie School v. Patch, 933 A.2d 382 (Md. 2007) (a non-breaching party has no duty to mitigate damages where the parties agree to a valid liquidated sum in the event of a breach). As the Barrie court noted:

> Liquidated damages differ fundamentally from mitigation of damages. While mitigation is part of a court's determination of actual damages that have resulted from a breach of contract, liquidated damages clauses are the remedy the parties to a contract have determined to be proper in the event of breach. Where the parties to a contract have included a reasonable sum that stipulates damages in the event of breach, that sum replaces any determination of actual loss.…It follows naturally that once a court has

> determined that a liquidated damages clause is valid, it need not make further inquiries as to actual damages. This includes a determination of whether the parties attempted to mitigate damages resulting from breach.

Id. at 392 (citations omitted).

12. Is a "Shotgun" liquidated damages clause enforceable?

Maryland appellate courts have not specifically addressed this issue in a reported decision in the context of a commercial real estate purchase and sale agreement. A "shotgun" liquidated damages clause gives a seller the right to liquidated damages, regardless of the materiality of the breach. It is a "settled rule of law" in Maryland that the amount of the liquidated damages "cannot be grossly excessive and out of all proportion to the damages that might reasonably have been expected to result from" a contractual breach. Baltimore Bridge Co. v. U. Rwys. & E. Co., 93 A. 420, 422 (Md. 1915). This language suggests that a court will analyze whether the liquidated damages provision is reasonable in the context of the materiality of the breach triggering the application of that provision. Massachusetts Indemnity and Life Ins. Co., supra, 306 A.2d at 217. Interestingly, in an 1896 decision involving a bid to provide desks and other goods to Baltimore City schools, Maryland's highest court remarked that it would be "unconscionable" for the City to retain a $500 bid deposit for a "*technical* breach which has occasioned no appreciable injury." Willson v. Mayor and City Council of Baltimore, 34 A. 774, 776 (Md. 1896) (emphasis added).

13. Does a liquidated damages clause preclude recovery of attorneys' fees by the seller?

Recovery of attorneys' fees is governed by the terms of the contract and is not viewed as damages. "[I]n the absence of identifiable misconduct such as fraud, overreaching, misrepresentation, or void as to other creditors, a trial court may not alter the terms of a valid contract as a matter of discretion. The parties have a right to contract and to have the terms of their contract honored." Noyes Air Conditioning Contractors v. Wilson Towers Ltd. Ptshp., 712 A.2d 126, 131 (Md. Ct. Spec. App. 1998). Cf. Archway Motors, Inc. v Herman, 394 A.2d 1228, 1231–32 (Md. Ct. Spec. App. 1978) (declining to adopt the proposition that counsel fees are proper ancillary monetary damages in a specific performance suit).

LIQUIDATED DAMAGES IN WASHINGTON STATE PURCHASE AND SALE AGREEMENTS



GARY FLUHRER is a Member, **SCOTT OSBORNE** is Of counsel, **MICHELLE RUSK**, is an Associate with Foster Pepper, PLLC, in Seattle, Washington.

Washington State case law directly addresses the nature and role of liquidated damages in commercial real estate purchase and sale agreements. Washington courts have historically remained open to the remedy of either liquidated damages or specific performance in this context, as well as the alternative of recovering actual damages, if the parties have contracted to preserve such a remedy. However, the Washington State legislature's passage of a "Safe Harbor" statute in the early 1990's implemented a manner by which parties can assure liquidated damages will serve as the exclusive remedy in case of breach. Now, contracting parties may choose to conform to the Safe Harbor's limitations (earnest money amount totaling less than five percent of purchase price), but foreclose alternative remedies otherwise contractually available, including actual damages.

May the seller choose specific performance instead of liquidated damages (so that liquidated damages are not an exclusive remedy)?

Washington State case law provides that specific performance is available absent language specifying liquidated damages as the sole remedy.[1] In Washington State, courts acknowledge the "long-held rule" that "a liquidated damages clause in a real estate purchase and sale contract does not foreclose the remedy of specific performance absent language in the contract specifying liquidated damages to be the sole and exclusive remedy."[2] However, while case law establishes liquidated damages are not an exclusive remedy, Washington State's "Safe Harbor" statute supplies a method by which forfeiture of the earnest money upon a buyer default, as liquidated damages, *may* be made an exclusive remedy, provided that the earnest money is five percent or less of the purchase price.[3]

May the seller choose actual damages instead of liquidated damages (so that liquidated damages are not an exclusive damage remedy)?

While Washington courts will adhere to a clause obligating sellers to the exclusive remedy of liquidated damages if the Safe Harbor statute is utilized[4], a liquidated damages clause does not necessarily preclude a party from suing for actual damages, if the contract so provides.[5] However, case law implies a liquidated damages clause, alone, with no express reservation of the right to also seek actual damages would preclude such a right.[6]

If the seller may choose liquidated damages or actual damages, may it have both?

Washington courts will uphold liquidated damages clauses so long as the sums involved do not constitute a penalty.[7] The simultaneous pursuit of both liquidated damages and actual damages generally constitutes a sum amounting to a penalty, and the remedies should be sought in the alternative.

If the seller may choose liquidated damages or actual damages, but not both, when must it decide?

As a general matter, parties must elect at the time of contracting what remedies will be available. If parties wish to have forfeiture of the earnest money as liquidated damages serve as the exclusive remedy, the agreement should reflect that, in accordance with the Safe Harbor statute (provided that the earnest money deposit is 5% or less of the purchase price.) If parties wish to retain other remedies (i.e. actual damages or specific performance), the right to pursue those remedies in the alternative should be expressly reserved in the contract. But, the Safe Harbor statute will then not be available. Assuming that the right to pursue liquidated damages or actual damages was reserved in the agreement, then Washington State case law suggests the parties may plead in the alternative.[8]

Is there an applicable statute addressing liquidated damages clauses?

Yes, Washington State has a "Safe Harbor" statute, addressing liquidated damages in the context of real property purchase and sale agreements.[9] Under RCW 64.04.005, a liquidated damages agreement stating that retention of the earnest money, or liquidated damages, is the exclusive remedy for a buyer default in closing the purchase will be enforceable, regardless of actual damages or the reasonableness of such amount, *if the earnest money deposit is five percent or less of the sale price*.[10] The application of the statute's safe harbor is contingent on the exclusivity of earnest money forfeiture as liquidated damages as the seller's sole remedy. Furthermore, as confirmed in case law, if the statute does not apply (in cases where the amount of the deposit exceeds five percent) the safe harbor is not available.[11] The fact the safe harbor is not available does not render the liquidated damage provision unenforceable; it merely removes the contractual provision from the application of the statute.

What is the test for a valid liquidated damages clause?

The Washington State Supreme Court discussed the test for valid liquidated damages clauses in companion cases: Wallace Real Estate Inv., Inc. v. Groves[12] and Watson v. Ingram.[13] The court rejected prior case law utilizing a 3-prong test, opting instead for a "single-factor" approach, focusing on the reasonableness of the estimate of loss.[14] In doing so, the Court discussed that proof of actual damages is not required, but courts may consider them to evaluate the reasonableness of the estimate. A provision bearing no reasonable relation to actual damages will be construed as a penalty.[15]

Who has the burden of proof?

While not discussed thoroughly, Washington case law denotes the burden is on the non-breaching party to establish the reasonableness of a liquidated damages provision.[16]

As of when is "reasonableness" tested?

The reasonableness of liquidated damages is measured at the time of contract formation.[17]

What percentage of the purchase price is likely acceptable as liquidated damages?

Under Washington's Safe Harbor statute, an agreement for an earnest money deposit that is five percent or less of the purchase price, and which expressly states forfeiture of the earnest money is the exclusive remedy, will be upheld, *regardless* of whether the earnest money is a reasonable estimate of damages or the seller incurred any damages. Most buyers and sellers in Washington State utilize this Safe Harbor statute.

As evidence of the outer limits, a liquidated damages provision in a commercial real estate contract was upheld as not unreasonable where the total sum forfeited by nonperformance by purchaser's assignee amounted to 17 percent of a contract price of $1,520,000.[18] We consider this result unusual and resulting from the specific facts of the case.

Are actual damages relevant for liquidated damages and, in particular, will liquidated damages be allowed when there are no actual damages?

Washington case law generally does not impose the requirement of actual damages as part of its test for determining the validity of a liquidated damages clause.[19] However, actual damages may be pertinent for purposes of determining whether a liquidated damages amount is reasonable, in unusual cases.[20] Additionally, actual damages are irrelevant if one falls under the Safe Harbor statute.

Is mitigation relevant for liquidated damages?

Washington case law does not discuss the role of mitigation and liquidated damages clauses in the context of commercial real estate transactions. Mitigation is not relevant under the Safe Harbor statute.

Is a "Shotgun" liquidated damages clause enforceable?

Washington case law does not utilize the phrase "shotgun" clause with respect to liquidated damages provisions. However, the Washington Court of Appeals held a breach must be material, in denying a party liquidated damages when the breach was immaterial.[21]

Does a liquidated damages clause preclude recovery of attorneys' fees by the seller?

It would appear no; Washington courts will look to the language of the purchase and sale contract to ascertain whether the parties contracted for recovery of attorneys' fees as part of the remedy available to the prevailing party.[22]

CONCLUSION

Washington State recognizes the freedom parties to commercial real estate purchase and sale agreements to contract for certain remedies, including but not limited to, liquidated damages. Increasingly, parties elect to enjoy the "safe harbor" provided by RCW 64.04.005, but this statute does not foreclose parties' abilities to retain alternate remedies should they choose.

APPENDIX A

RCW 64.04.005

Liquidated damages—Earnest money deposit—Exclusive remedy—Definition.

(1) A provision in a written agreement for the purchase and sale of real estate which provides for liquidated damages or the forfeiture of an earnest money deposit to the seller as the seller's sole and exclusive remedy if a party fails, without legal excuse, to complete the purchase, is valid and enforceable, regardless of whether the other party incurs any actual damages. However, the amount of liquidated damages or amount of earnest money to be forfeited under this subsection may not exceed five percent of the purchase price.

(2) For purposes of this section:

(a) "Earnest money deposit" means any deposit, deposits, payment, or payments of a part of the purchase price for the property, made in the form of cash, check, promissory note, or other things of value for the purpose of binding the purchaser to the agreement and identified in the agreement as an earnest money deposit, and does not include other deposits or payments made by the purchaser; and

(b) "Liquidated damages" means an amount agreed by the parties as the amount of damages to be recovered for a breach of the agreement by the other and identified in the agreement as liquidated damages, and does not include other deposits or payments made by the purchaser.

(3) This section does not prohibit, or supersede the common law with respect to, liquidated damages or earnest money forfeiture provisions in excess of five percent of the purchase price. A liquidated damages or earnest money forfeiture provision not meeting

the requirements of subsection (1) of this section shall be interpreted and enforced without regard to this statute.

Notes

1 Paradise Orchards Gen. P›ship v. Fearing, 122 Wn. App. ,507 94 P.3d 2004) 372); see also Save-Way Drug v. Standard Investment, 5 Wn. App. 490 ,728 ,726 P.2d 1971) 1342) (“The fact that a contract contains a provision for the payment of a penalty or liquidated damages for breach… is not a bar to the specific enforcement of the promise”).

2 Paradise Orchards Gen. P›ship v. Fearing, 122 Wn. App. 94 ,518 ,507 P.3d 2004) 372)(citing Asia Inv. Co. v. Levin, 118 Wash. 204 ,627-624 ,620 P. 1922) 808)).

3 RCW 64.04.005 (see Appendix A for complete text of statute).

4 Id.

5 See Noble v. Ogborn, 43 Wn. App. 717 ,391 ,387 P.2d 285 1986))(“A liquidated damages clause does not preclude a party from suing for actual damages if that right is preserved in the contract between the parties.”); see also Reiter v. Bailey, 180 Wash. 39 ,230 P.2d 1934) 370).

6 *See* Mahoney v. Tingley, 85 Wn.2d 529 ,95 P.2d 1975) 1068).

7 Wallace Real Estate Inv., Inc. v. Groves, 124 Wn.2d ,886 ,881 881 P.2d 1994) 1010).

8 See Noble v. Ogborn, 43 Wn. App. 717 ,387 P.2d 1986) 285) (Court rejected breaching party’s argument that non-breaching party (Noble) was precluded from seeking other relief when Noble sued for liquidated damages; Noble pleaded in his complaint in the alternative for specific performance, liquidated damages, or actual damages, thus no election was made, which is permissible under CR8(a)).

9 RCW 64.04.005.

10 Id. (emphasis added).

11 Paradise Orchards Gen. P›ship v. Fearing, 122 Wn. App. 94 ,519-518 ,507 P.3d 2004) 372).

12 124 Wn.2d 881 ,881 P.2d 1994) 1010).

13 124 Wn.2d 881 ,845 P.2d 1994) 247).

14 Wallace Real Estate Inv., Inc. v. Groves, 124 Wn.2d ,893 ,881 881 P.2d 1994) 1010)(citing Watson v. Ingram, 124 Wn.2d 881 ,845 P.2d 1994) 247)).

15 Id.

16 Watson, 124 Wn.2d at 851.

17 Watson v. Ingram, 124 Wn.2d 881 ,854 P.2d at 1994) 247); see also Wallace Real Estate Inv., Inc. v. Groves, 124 Wn.2d 881 ,890 ,881 P.2d 1994) 1010) (“Our prior case law… supports the position…that reasonableness at the time of contracting is the key in evaluating liquidated damages clauses”).

18 Wallace Real Estate Inv., 124 Wn.2d 1994) 881).

19 Wallace Real Estate Inv., Inc. v. Groves, 124 Wn.2d ,881 881 ,892, P.2d 1994) 1010) (“We thus conclude that proof of actual damages is not required as a prerequisite to upholding a liquidated damages clause...”).

20 Id. at 894 (“[W]hile proof of actual damages is no longer a requirement… actual damages may be considered where they are so disproportionate to the estimate that to enforce the estimate would be unconscionable»).

21 McEachren v. Sherwood & Roberts, Inc., 36 Wn. App. ,576 675 P.2d 1984) 1266) (Breaching party did not a sign rental agreement).

22 Id.; see also Woodruff v. McClellan, 95 Wn.2d 622 ,394 P.2d 1980) 1268) (Where both sides sought attorneys’ fees pursuant to an earnest money agreement—stating that in event either party institutes suit to enforce rights under agreement, the successful party shall be entitled to reasonable attorneys’ fees—the prevailing party was entitled to the same).

LIQUIDATED DAMAGES IN FLORIDA PURCHASE AND SALE AGREEMENTS

ARTHUR J. MENOR is the Managing Partner of the West Palm Beach office of Shutts & Bowen LLP, and Chairman of the Real Estate Leasing Practice Group.

A nationally recognized real estate lawyer, Art has over 38 years of experience in all facets of commercial real estate, focusing on commercial leasing and the acquisition and disposition of commercial real estate. He advises landlords and tenants in various aspects of the leasing process and also counsels developers, investors, and lenders. As a seasoned veteran, Art has worked on real estate projects of all sizes and has mastered his craft in improving the lease drafting and negotiation processes, including using technology to build and customize high-quality leasing documents in a cost-effective manner.

Art has consistently been recognized by his peers, rating services, and the community. He is a fellow of the American College of Real Estate Lawyers, which recognizes distinguished, nationally-known lawyers for their outstanding legal ability, and high standards of professional and ethical conduct in the practice of real estate law. He is one of seven Most Distinguished Attorneys in the 2015 South Florida Legal Guide and is the only attorney listed as its Top Lawyer in commercial leasing.

The author wishes to acknowledge the substantial contributions to this article made by his colleagues, Alfred A. LaSorte and Seth L. Coleman.

This article is submitted as part of the ongoing project of the ACREL Acquisitions Committee to answer the following 13 questions related to the liquidated damages remedy in commercial purchase and sale agreements under the law of various states. Here are the answers to the questions as discerned through research of Florida law.

1. May the seller choose specific performance instead of liquidated damages (so that liquidated damages are not an exclusive remedy)?

Under Florida law, assuming there is no provision in a contract to purchase real property providing differently, upon a breach of the contract by the buyer, the seller generally has two alternative remedies: 1) he may sue to compel specific performance and, as an incident to such relief, may be awarded damages for the injuries he has suffered, or 2) he may retain the property and sue for breach of contract. Frank Silvestri, Inc. v. Hilltop Developers, Inc., 418 So. 2d 1201, 1203 (Fla. 5th DCA 1982); Clements v. Leonard, 70 So. 2d 840, 843 (Fla. 1954). The specific performance remedy is available to the seller because money damages do not adequately compensate a seller burdened with ownership following the buyer's default. Specific performance is uniquely capable of rectifying the breach of such a contract. Bell v. Alsip, 435 So. 2d 840, 842 (Fla. 4th DCA 1983).

If the contract provides a liquidated damages remedy to the seller, Florida courts allow the seller to choose specific performance instead of liquidated damages unless the parties intend liquidated damages to be the exclusive remedy. If the terms of the contract clearly show that liquidated damages is intended to be the exclusive remedy than the seller may not pursue specific performance. Dillard Homes, Inc. v. Carroll, 152 So. 2d 738 (Fla. 3d DCA 1963). A Florida court reviewing a contract that provides that the seller is entitled to liquidated damages and thereafter the contract is terminated, would likely find that liquidated damages is the seller's sole remedy even in the absence of language expressly providing that liquidated damages is the sole remedy.

Further, a contract may provide for liquidated damages in the event of a breach, while also providing the alternative remedy of specific performance without rendering the liquidated damages provision unenforceable. Mineo v. Lakeside Village of Davie, LLC, 983 So. 2d 20 (Fla. 4th DCA 2008) citing Lefemine v. Baron, 573 So. 2d 326, 328 (Fla. 1991). San Francisco Distribution Center, LLC v. Stonemason Partners, LP, 183 So.3d 391 (Fla. 3d DCA 2014).

2. May the seller choose actual damages instead of liquidated damages (so that liquidated damages are not an exclusive remedy)?

A contract provision that provides the seller the option of receiving the deposit as liquidated damages or suing for actual damages renders the liquidated damages provision unenforceable. In Lefemine, *the Florida Supreme Court said*: "The reason why the forfeiture clause must fail in this case is that the option granted to Baron either to choose liquidated damages or to sue for actual damages indicates an intent to penalize the defaulting buyer and negates the intent to liquidate damages in the event of a breach." The purpose of the liquidated damages provision within an agreement is to fix the seller's damages recovery at an agreed amount. In Florida, the mere existence of an option to sue for actual damages will render a liquidated damages provision in an agreement an unenforceable penalty provision. Lefemine.

3. If the seller may choose liquidated damages or actual damages, may it have both?

As provided in the answer to Question 2 above, a seller may not choose between actual and liquidated damages, therefore, the seller cannot have both.

4. If the seller may choose liquidated damages or actual damages, but not both, when must it decide?

In Florida, a seller may not choose between liquidated damages or actual damages. See the answers to Questions 2 and 3 above. In Lefemine, the court also found the liquidated damages clause to be unenforceable because the clause, as written, would have allowed the seller to exercise its option after the actual damages were known: "if the actual damages are less than the liquidated sum,…the seller will take the deposit..." Lefemine, supra, at 330.

5. Is there an applicable statute addressing liquidated damages clauses?

There is no Florida statute that addresses liquidated damages in contracts for the sale of commercial real estate.

6. What is the test for a valid liquidated damages clause?

As more fully discussed in Carey, Liquidated Damages in a Real Estate PSA: a Closer Look, The Practical Real Estate Lawyer, January 2019, the traditional test to determine the validity of a liquidated damages clause has three prongs: (1) intent (the parties must intend to provide for damages and not a penalty); (2) uncertainty (as to the amount of damages that will result from the breach); and (3) reasonableness (the sum stipulated must be a reasonable pre-estimate of the probable loss). In Florida, courts have consistently only discussed the second and third prongs.

In Hyman v. Cohen, 73 So. 2d 393 (Fla. 1954), the Florida Supreme Court established a two-prong test to determine if a liquidated damages clause is enforceable or if it will be stricken as a penalty clause. First, the damages consequent upon a breach must not be readily ascertainable at the time the contract is entered into (i.e., the uncertainty prong of the traditional test); second, the sum stipulated to be forfeited must not be so grossly disproportionate to any damages that might reasonably be expected to follow from a breach as to show that the parties could have intended only to induce full performance, rather than to liquidate their damages (i.e., the reasonableness prong with a bit of a conflation with the intent prong of the traditional test). Hyman.

Even though the Florida courts have repeatedly stated that the test for enforceability of a liquidated damages provision is a two prong test, the second prong of the Florida test seems to include the both the first and third prongs of the traditional test. In any case, Florida courts use the Florida two prong test, in addition to the plain reading of the contract, to ascertain whether it was the intent of the parties to liquidate damages (which is permissible) or to induce performance (which is not). Thus, the first prong of intent from the traditional test seems to be the touchstone of the Florida law enforceability analysis even though it is not expressly stated to be a separate part of the test.

7. Who has the burden of proof?

No Florida cases were found that directly answered this question. However, in most of the cases the buyer was seeking to invalidate the liquidated damages provision and as the plaintiff had the burden of proof. In addition, in the decision in Lewis v. Belknap, 69 So. 2d 212 (Fla. 1957) the court stated that where two mature people are dealing with each other at arm's length, then the deposit amount is presumptively liquidated damages and not a penalty which would lead to the conclusion that the buyer has the burden of proof in rebutting this presumption. Finally, in Valenti v. Coral Reef Shopping Center, Inc., 316 So. 2d 589 (Fla. 3d DCA 1975), the lower court was found in error for requiring the seller to show that the subject properties depreciated in value since the signing of the contracts which implicitly shows that the buyer rather than the seller has the burden of proof.

8. As of when is "reasonableness" tested?

Whether a liquidated damages provision meets the tests to be enforceable is determined as of the date the contract is entered into, not a later date, such as the date that damages are suffered as a result of the breach. Hyman, at 401; Lefemine. The amount stipulated in the contract to be liquidated damages must be reasonable under the circumstances at the time of execution of the contract, "since the land sale market in Florida fluctuates from year to year and it is generally impossible to say at the time a contract for sale is drawn what the vendor's loss will be should the contract be breached by the purchasers." Valenti.

9. What percentage of the purchase price is likely acceptable as liquidated damages?

Florida courts have consistently held that liquidated damages provisions for 10 percent of the purchase price of the property are acceptable, with some decisions upholding percentages as high as 22 percent under appropriate facts. Kirkland v. Ocean Key Associates, Ltd., No. 07-10030-CIV, 2007 WL 3343083 at *2 (S.D. Fla. Nov. 8, 2007) (10% held reasonable); Hot Developers, Inc. v. Willow Lake Estates, Inc., 950 So. 2d 537, 541-42 (Fla. 4th DCA 2007) (9.65% upheld as liquidated damages and discussing ranges from 4.85 percent to 22 percent held to be reasonable); Bloom v. Chandler, 530 So. 2d 341 (Fla. 4th DCA 1988) (upholding a liquidated damages clause under which the sellers retained a $49,500 deposit as liquidated damages on a contract for $225,000 or 22 percent of the purchase price); Hooper v. Breneman, 417 So.2d 315, 318 (Fla. 5th DCA 1982) (upholding a liquidated damages provision calling for forfeiture of 13.3 percent of the purchase price); Ivanov v. Sobel, 654 So. 2d 991 (Fla. 3d DCA 1995) (10 percent held not to be grossly disproportionate); Johnson v. Wortzel, 517 So.2d 42 (Fla. 3d DCA 1987) (18.2 percent was not sufficient enough to shock the conscience of the court).

10. Are actual damages relevant for liquidated damages and, in particular, will liquidated damages be allowed when there are no actual damages?

The amount of actual damages, if any, is irrelevant to the enforceability of a liquidated damages provision in a real estate contract in Florida. In fact, in one case it was found that the lack of actual damages could not be used as a defense to enforcement of a liquidated damages provision with the court ignoring the fact that the party enforcing the provision had actually profited by selling the subject property to a third party for a higher price than the contracted price. San Francisco Distribution Center. In reaching this conclusion the court noted that the real estate market fluctuates from year to year and even from season to season. Since the validity of a liquidated damages provision is measured on the date the contract is made, and at that time future market conditions are unknowable, the seller's ultimate future actual damages are irrelevant. See also, Valenti.

11. Is mitigation relevant for liquidated damages?

No Florida cases were found that addressed this issue. However, because the validity of a liquidated damages remedy is not contingent upon the ultimate amount of actual damages incurred, if any, the concept of mitigation of damages should be irrelevant. Courts in other jurisdictions support this view. See, NPS, LLC v. Minihane, 886 N.E.2d 670, 675 (2008) (when parties agree in advance to a sum certain that represents a reasonable estimate of potential damages, they exchange the opportunity to determine actual damages after a breach, including possible mitigation, for the "peace of mind and certainty of result" afforded by a liquidated damages clause.)

12. Is a "Shotgun" liquidated damages clause enforceable?

No Florida cases were found dealing with a seller attempting to retain a deposit as liquidated damages for a buyer's default other than in failing to close. However, in a lawsuit regarding a breach of a lease, the Florida Supreme Court stated, "where an agreement is to pay the same sum for a partial as for a total breach or is to secure the performance of covenants of widely varying importance for any of which the sum is excessive, it will be regarded as a penalty." Stenor, Inc. v. Lester, 58 So.2d 673 (Fla. 1951) citing Greenblatt v. McCall, 67 Fla. 165, 64 So. 748 (Fla. 1914) and Smith v. Newell, 34 Fla. 165, 20 So. 249 (Fla. 1896).

13. Does a liquidated damages clause preclude the recovery of attorneys' fees by the seller?

There are two scenarios in which the recovery of attorneys' fees in addition to liquidated damages could be attempted: (1) the recovery of attorneys' fees incurred by the seller in preparing and negotiating the contract with the defaulting purchaser prior to the date of default; and, (2) the recovery of attorneys' fees incurred in litigation to retain (or recover) the liquidated damages.

As to the first scenario, if the seller is entitled to and obtains liquidated damages for the buyer's default, then, as discussed in the answer to Question 2, the seller will likely not be entitled to recover any additional amount of actual damages for that breach, including attorneys' fees incurred by the seller in the underlying transaction or a subsequent sale of the property to another buyer. Lefemine. A Florida court would likely refuse to allow a seller to recover, in addition to retaining the deposit as liquidated damages, the attorneys' fees incurred by the seller in preparing for, negotiating, documenting, and closing the sale to the defaulting buyer or a sale to a replacement buyer, as those costs are viewed as part of the seller's damages that have been liquidated.

On the other hand, as to the second scenario, attorneys' fees incurred in litigation to recover (or retain) the liquidated damages would likely be recoverable, so long as such fees were permitted by contract or statute. If the agreement between the parties includes a clause giving the prevailing party the right to attorneys' fees and costs for any litigation associated with the contract, then the prevailing party would likely be entitled to recover those fees and costs in addition to the liquidated damages.

Although no Florida case was found in which a buyer argued that retention of the deposit as liquidated damages precluded the seller from recovering attorneys' fees in the action to claim the deposit, there is at least one Florida case where the recovery of fees was expressly permitted in an action in which the deposit was awarded to the seller as liquidated damages. Erwin v. Scholfield, 416 So. 2d 478 (Fla. 5th DCA 1982). Although it was not an issue in the appeal, attorneys' fees were also awarded to the seller in San Francisco Distribution. Attorneys' fees incurred in litigation to retain the deposit do not flow from a breach of the buyer's obligation to purchase, but rather from the buyer's resistance to the payment to (or retention by) the seller of the liquidated damages, and are awarded under a separate clause within the contract.

RESTAURANT LEASING: PERMITTED USE AND EXCLUSIVES

MINDY WOLIN SHERMAN is a Partner with Perkins Coie LLP, in Chicago. Shehas more than 35 years of experience in the leasing, acquisition, disposition, development and redevelopment of real estate, including retail, commercial, office and hotel properties. She also has extensive experience in the handling of all real estate aspects of mergers and acquisitions of all types of entities. Her work also includes advising clients on the redevelopment and redeployment of their real estate assets. She is a Fellow of the American College of Real Estate Lawyers is a member of the Planning Committee for the International Council of Shopping Centers Law Conference, served on the Advisory Board of the Georgetown University Advanced Commercial Leasing Institute for 15 years and frequently speaks at programs on the subject of retail leasing. An earlier version of this article appeared in the Fall 2018 ACREL papers.

PERMITTED USE

The use of a premises is often a tug-a-war between landlord and tenant. Landlords favor narrow use provisions in order to protect their ability to maintain a mix of tenants in their development, including the types of restaurants operating in the project. From a landlord's perspective, the use clause should, at a minimum, specify the type of restaurant (e.g., quick service, fast casual, casual dining, fine dining) and type of cuisine offered (e.g., Mexican, Italian, American). The use clause is important to a landlord as it is a means of ensuring that it gets the use it expects, not just upon the opening of the restaurant but for the duration of the lease. Landlords may also want to control the types of restaurants located at their venues. For instance, a landlord's vision of its venue may include all higher price point restaurants to complement a higher price point retail area or it may involve a diverse mix of fast casual restaurants with little or no duplicative uses.

In an ideal situation, landlords would like to see a use clause in the lease which limits the trade name of the tenant and food offerings. In addition, landlords prefer to attach a menu as an exhibit to a lease to establish the parameters of a potential tenant's use. Here is an example:

> Tenant shall operate the Premises under the trade name "[Trade Name]" and shall use the Premises solely for the purpose of conducting the business of a [Theme]-themed restaurant offering for sale only those items listed on Exhibit attached hereto and made a part hereof, and for no other purpose whatsoever.

On the other hand, in order to protect its flexibility and provide an exit strategy (more important given the generally longer terms for restaurant leases), a tenant prefers a broad use clause such as "restaurant or any lawful use." Tenants will want as much freedom as possible in order to change both its menu and trade name, as well as change the restaurant concept, as customer trends and tastes evolve over time. However, tenants should understand that certain conceptual parameters will need to be established to make their landlords comfortable with these provisions.

In addition, some restaurant tenants may want to include a small retail component to their offerings. Obviously, landlords want to make sure the location remains primarily a restaurant and not become a retail or hybrid concept. Depending on how the use clause is drafted, it may protect or limit the ability of the restaurant to undergo periodic changes in design or concept, changes generally desired by tenants to track market trends or adhere to franchisor requirements. What a lease states a tenant may or may not do at the onset will go far towards determining the extent of control a tenant has over the life of the lease.

A more elastic use clause can accommodate some of the tenant's needs to change over the term of the lease while addressing the concerns of the landlord. To reach a happy medium and to allow tenants to survive changing market trends, landlords will sometimes allow for an expanded use clause after operating for a period of time under a specified initial use, subject to any new prohibited or exclusive uses granted by the landlord since the lease was first signed. Another option for parties wanting to provide the tenant some flexibility is to limit the percentage of sales or square footage of the premises which are devoted to the new use (with reporting requirements for verification). If a tenant is unable to obtain sufficient flexibility in its use clause, a tenant may try to include a right to terminate the lease if its business does not generate a threshold amount of sales. Both parties must navigate the tension between limiting the use clause and allowing a business to adapt and succeed.

The clause below not only attempts to strike the needed balance, it also provides a starting point for the overall discussion of what concept will be presented at the location. Here is an example:

> Tenant shall operate the Premises under the trade name "[Trade Name]" and shall use the Premises solely for the purpose of conducting the business of a [Theme]-themed restaurant offering for sale only those food and beverage items contained in the menu attached hereto and made a part hereof as Exhibit ___, provided that Tenant may change individual food and beverage items on such menu without Landlord's consent if the menu, as changed: (A) contains the same food and beverage items sold by all, or substantially all, other "[Trade Name]" locations in the [Geographical Area], and (B) is consistent with a [Theme]-themed restaurant, and Tenant may also sell at retail, as an incidental use, "[Trade Name]" labeled promotional items (such as hats, t-shirts, and gift cards), provided however, that the portion of the Premises used for the sale of such incidental items shall not be greater than [Size] square feet in the aggregate, and for no other purpose whatsoever.

EXCLUSIVES, PROHIBITED USES AND USE RESTRICTIONS

Similar tensions exist with respect to exclusivity. Restaurant tenants are territorial in nature. For example, a high-end Italian restaurant will not want another high-end Italian restaurant (or, for that matter, any other high-end restaurant) nearby and, therefore, may want to restrict landlord's ability to use the remainder of its property for such uses. It is in the tenant's interest to obtain an exclusive right to a portion of the restaurant market, either to become "the" restaurant in the area serving its type of food, or to reap the benefit of having established a thriving market by opening another restaurant near their existing one. Finding an acceptable compromise on exclusivity is important to allow a restaurant to remain popular and attractive in a competitive market.

Crafting exclusive clauses requires a balancing act to make the clause narrow enough to both allow a landlord the flexibility to lease the rest of its property and be enforceable, yet broad enough to protect a tenant's intended use, as the same may evolve. Landlords should be careful to limit the protected use to the type of restaurant (e.g., fast food, sit-down) and to clearly define the protected items (e.g., if the items are sandwiches, what is a sandwich?). Exclusive provisions should also be descriptive enough to capture a niche or novel cuisine, such as fusion, or specific enough to eliminate competition from an actual named competitor and not just any restaurant that serves the same type of food to a different customer base. Allowing a tenant the protection of an exclusive use may encourage other tenants to request similar protections, thus extending the list of prohibited uses for future tenants ad infinitum. Because of this, and to allow flexibility for changes of use, landlords must carefully keep a specific list of all exclusive and prohibited uses within their leases and title restrictions.

White City Shopping Center, LP v. PR Restaurants, LLC, No. 2006196313, 2006 WL 3292641, at *1 (Mass. Super. Oct. 31, 2006) highlighted the difficulties of crafting an effective exclusive use provision while ensuring new tenants do not violate an exclusive use right. White City concerned the exclusive granted to Panera Bread, a restaurant in the subject shopping center selling sandwiches and soups. The clause stated "Landlord agrees not to enter into a lease, occupancy agreement or license affecting space in the Shopping Center or consent to an amendment to an existing lease permitting use … for a bakery or restaurant reasonably expected to have annual sales of sandwiches greater than ten percent (10%) of its total sales or primarily for the sale of high quality coffees or teas, such as, but not limited to, Starbucks, Tea-Luxe, Pete's Coffee and Tea, and Finagle a Bagel." Id. at *1. The lease contained no definition of "sandwich" and only listed several chain restaurants who would be prohibited based on the exclusive. When Qdoba, a Mexican-themed fast food restaurant that sells burritos, tacos, and quesadillas leased space in the shopping center, the landlord sought a declaratory judgment stating that the sale of burritos, tacos and quesadillas did not violate Panera's exclusive use. Panera responded by filing a preliminary injunction to block Qdoba's operations, claiming among other things, a breach of contract, breach of implied covenant of good faith and fair dealing, and a violation of the consumer protection statute. The court, in denying Panera's motion for a preliminary injunction and finding the exclusive use provision undisturbed, noted Panera's lack of specificity and forethought in crafting the provision. It stated, "[b]ecause [Panera] failed to use more specific language or definitions for 'sandwiches' in the Lease, it is bound to the language and the common meaning attributable to 'sandwiches' that the parties agreed upon when the Lease was drafted." Id. at *4. The ordinary meaning used by the Court, undefined by the parties, was the dictionary definition of a sandwich: "two thin pieces of bread, usually buttered, with a thin layer (as of meat, cheese, or savory mixture) spread between them." Id. at *3 (citing The New Webster Third International Dictionary, 2002). Burritos and tacos did not meet this definition, and thus the court did not deem Panera's exclusive use to have been violated.

To circumvent some of the problems illustrated by the White City case, parties should carefully craft specific language defining what is and is not included in the exclusive use. A landlord should include carve-outs for existing tenants (and their successors and assigns), anchor stores, incidental uses (e.g., serving pastries in a full-service restaurant would not violate a bakery's exclusive use), and tenants over and/or under a certain size. Other issues to address in an exclusive clause include:

1. Does the exclusive remain in effect in the event of an assignment or sublease;
2. Does the exclusive remain in effect if tenant ceases to operate;
3. Does the exclusive remain in effect during any extension periods;
4. What should be the remedies for a breach by landlord and should they depend on whether or not the breach was intentional; and
5. Should the agreed-upon remedies for breach of an exclusive be in lieu of all other available remedies?

Specified limitations on exclusive use restrictions provide certainty for both parties and enhance enforceability. Exclusives can be limited by geography - the food court, only one corridor, or the portion of the center which the landlord owns - or they can consist of a radius provision that prevents the leasing of property by landlord within a restaurant's market. Exclusive use clauses can prohibit specific named tenants or chains, be limited to a specific per person check average (PPA), and/or delineate between uses where alcohol is permitted and where it is not (and can even include gross sales percentage guideposts to distinguish between restaurants and bars, for example).

While exclusive use provisions protect a restaurant's business, they open the door for landlord liability. Landlords often worry about anti-trust claims and seek to pass the risk of such a claim to the tenant by requiring that either tenant forego the exclusive or indemnify landlord for any anti-trust claims made against landlord in connection with the granting of an exclusive. Aside from a landlord's liability for its intentional breach of an exclusive granted by landlord, a landlord may be liable for the actions of another "rogue" tenant that breaches the protected use, potentially requiring the landlord to institute enforcement proceedings against the violating tenant yet wanting to otherwise keep the violating tenant in the project. Remedies for violation of an exclusive may include liquidated damages and/or a right to terminate the lease with a potential investment reimbursement, reductions in rent, or equitable remedies, all of which can have ramifications on the landlord's financing and investors. A landlord concerned about some of these potential issues can sometimes be persuaded to nonetheless grant a tenant exclusive use protection if the tenant agrees to limit the length or severity of the remedy, such as (a) rent abatement in proportion to the demonstrated decreased earnings, (b) a specified time period in which the tenant may exercise the remedy and after which the tenant either continues despite the breach or terminates the lease, or (c) liquidated damages serving as the sole remedy.

In an effort to balance the needs and wants of both parties, the below exclusive provision provides the tenant with a protection from competitors, but also enables the landlord to develop and remix its venue. Here is an example:

> (a) Notwithstanding anything contained in this Lease to the contrary, but subject to this Section _____, provided (i) this Lease is in full force and effect, (ii) Tenant is not then in breach of any of the terms, covenants or conditions of this Lease required to be observed or performed by Tenant, and (iii) Tenant is open and operating in the Premises in accordance with the terms of this Lease, if after the date of this Lease, Landlord enters into a lease with a Competing Tenant (as hereinafter defined) and the Competing Tenant thereafter operates its premises within the Shopping Center primarily as a Competing Use (as hereinafter defined) for a period of ( ) days following Tenant's notice thereof to Landlord (the "Competing Use Cure Period"), then [Insert remedy here] for so long as the Competing Tenant continues to operates its premises primarily as a Competing Use. The benefits of this Section __ are personal to the named Tenant under this Lease. In the event of any assignment of the Lease by Tenant or sublease of all or any part of the Premises by Tenant, this Section __ shall be null and void and of no further force or effect. The foregoing sentence is not intended to, and does not, create any right of assignment or sublease by Tenant.
>
> (b) In the event Tenant is entitled to [Remedy for Exclusive Violation] for ____ (__) consecutive months, then at any time thereafter, Landlord may, at its sole discretion, terminate the Lease upon not less than ____ ( ) days' notice to Tenant. This Lease shall terminate at the end of said notice period without any additional action or notice by Landlord and Tenant shall have no further right, title or interest in or to the Premises, unless Tenant gives Landlord notice within ten (10) days of Landlord delivering said termination notice to Tenant that Tenant irrevocably and unconditionally agrees to [Undo whatever Remedy Existed].
>
> (i) The term "Competing Use" shall mean: [DEFINE RESTRICTED/EXCLUSIVE USE SCOPE].
>
> (ii) The term "Competing Tenant" shall mean any individual or entity that is not:
>
> (1) Tenant or a related entity, (2) a licensee, concessionaire, franchisee, assignee or sublessee of Tenant or any related entity, (3) any individual or entity occupying a premises in the Shopping Center which is equal to or [greater than/less than] ___________ square feet, (4) an individual or entity operating in the Shopping Center pursuant to an order or other action of a bankruptcy court or other similar judicial proceeding, or (5) a tenant or occupant of the Shopping Center operating in the Shopping Center pursuant to a renewal, modification, assignment or sublet of any lease or other agreement

entered into with such tenant or occupant prior to the date of this Lease (including, but not limited to, any renewals or modifications of such lease or other agreement which relocates, expands or otherwise reconfigures the premises which such tenant or occupant occupies) for so long as such lease or other agreement (or renewal thereof) remains in effect.

(d) Notwithstanding anything to the contrary contained in this Section , the following shall not be deemed Competing Uses:

(i) The operation of a theme restaurant, such as a sports or music-themed bar;

(ii) The primary use of the service of food and beverages, and incidental to such use, the performance of live or recorded music;

(iii) The operation of a restaurant that specializes in a single ethnic cuisine, such as Japanese, Chinese, Italian, French, German, Mexican, Spanish, Cuban, or Portuguese;

(iv) The operation of a restaurant that specialized in a single regional cuisine, such as Middle Eastern or Asian;

(v) The operation of a restaurant commonly known, as of the date of this Lease, as [List examples of restaurants], or similar type(s) restaurants; or

(vi) Any tenant or occupant whose premises is wholly or partially located in a "food court area" of the Shopping Center.

(e) Notwithstanding anything to the contrary contained in this Section ___, if a Competing Use is the result of the unauthorized actions of a tenant or occupant of the Shopping Center (e.g. operation of a Competing Use by a tenant or occupant of the Shopping Center without the consent of Landlord and/or in contravention of the terms and conditions of such tenant or occupant's permitted use pursuant to its lease or other applicable agreement), and Landlord commences and diligently pursues commercially reasonable efforts to cause such Competing Use to cease, then Tenant's right to the remedy available to Tenant pursuant to this Section ____ shall not be deemed to commence until the later of (i) the first day of the calendar month immediately following the end of the Competing Use Cure Period, and (ii) the first date upon which Landlord fails to expend such reasonable efforts and/or exhausts all available remedies of which Landlord may be entitled to seek to cause such Competing Use to cease.

CONCLUSION

While there is often a tug-a-war between landlord and tenant both with respect to a tenant's permitted use and any exclusive rights a tenant may be granted, if both parties want to consummate a transaction, there is a way to reach an agreement. In doing so, however, both parties need to carefully draft the relevant clauses so that during the lease term each party has the protections they thought they had.

THE USE OF MASTER LEASES IN COMMERCIAL REAL ESTATE TRANSACTIONS

JONATHAN TALANSKY is a partner in the tax and real estate practices of King & Spalding. He specializes in federal income taxation, with an emphasis on real estate private equity funds, public and private REITs, mergers and acquisitions, real estate investment trusts, infrastructure projects, capital markets, and real estate acquisitions and divestitures. Jonathan is one of the nation's leading experts and commentators on the federal "qualified opportunity zone" tax rules.

JADE NEWBURN is a partner in the real estate practice of Mayer Brown LLP. He is a member of the American College of Real Estate Lawyers, is recognized as a Recognized Practitioner by Chambers and is the Office Practice Leader for Real Estate in Mayer Brown's Chicago office. He is a frequent author, contributor and presenter on commercial real estate topics, including PERE Magazine, Crain's Chicago, the American College of Real Estate Lawyers and other industry events and publications.

An earlier version of this article appeared in the Fall 2018 ACREL papers. This article presents the personal opinions and experiences of the authors and not those of King & Spalding or Mayer Brown LLP.

The authors gratefully acknowledge the assistance of Ariana Wallizada and Irene Wilburn.

There is no single legal definition of a "master lease." Such an arrangement may be used in equipment leasing as well as in the real estate space. A master lease may be an alternative to traditional bank financing or a means of credit support. It also may figure prominently in the context of tax planning, most notably for entities taxed as "real estate investment trusts" ("REITs") under the U.S. Internal Revenue Code of 1986, as amended (the "Code").[1] This article will describe some of the uses of master lease structures for these purposes.[2]

MASTER LEASES AND TAX PLANNING

Tenancy in Common / Section 1031 Structures

Master leases may arise in Section 1031 like-kind exchanges. Section 1031 provides for the deferral of gain or loss on the exchange of business or investment property solely for property of "like kind."[3] The rationale behind the provision is that when an investor exchanges a piece of property for like-kind property, the investor is merely continuing an ongoing investment, rather than liquidating one to obtain another.[4] Thus, gain or loss is deferred until the investor's funds are no longer tied up in the same kind of property. In order to obtain such deferral, certain requirements must be met. The replacement property must be of like-kind with respect to the relinquished property.[5] It must be identified within 45 days of the transfer of the relinquished property, and generally must be received by the transferor within 180 days of the transfer of the relinquished property.[6] In addition, both the relinquished property and the replacement property must be held for productive use in a trade or business or for investment and must not be stock in trade, other property held primarily for sale, stocks, securities, partnership interests, and similar intangibles.[7] A "partnership" for such purposes includes any unincorporated organization through or by means of which any business, financial operation or venture is carried on.[8] Generally, and in light of the policy rationale behind Section 1031, the courts have interpreted its provisions liberally in order to allow taxpayers to come within its terms.[9]

Real estate syndicators have created an industry offering tenancy in common (TIC) interests in professionally managed rental real estate as the like-kind replacement property required to complete a Section 1031 exchange. A TIC is an undivided fractional interest in real property that is generally considered to be of like-kind with property that is wholly-owned. Syndicated TIC interests are easy to identify within the 45-day identification period and close on within the 180-day exchange period. In addition, TIC interests provide taxpayers with the opportunity to invest in rental real estate and achieve tax deferral, all without the burdens of managing the real estate. As attractive as TIC interests are, they do come with some risk. The common ownership of property has under certain circumstances been treated by the IRS and courts as a deemed partnership for tax purposes.[10] Thus, TIC arrangements intended to qualify for Section 1031 treatment must be structured carefully to prevent the interests from being treated as disqualifying interests in a partnership or other entity.

In 2002, the IRS issued a Revenue Procedure stating that the IRS "will consider a request for a ruling that an undivided fractional interest in rental real property… is not an interest in a business entity" if the arrangements meets the 15 conditions specified therein.[11] Those conditions, while not technically a safe harbor, are sometimes treated as such for planning purposes. The conditions include that all the tenants must hold their interests as a tenant in common under local law, there are no more than 35 TIC owners, the TIC owners must not hold themselves out as members of an entity or file any type of entity tax return, unanimous vote is required for the hiring of management and the sale, leases, or re-leases of the property or any portion of the property, and the TIC owners must not engage in business activities with respect to the property other than those that are "customary activities" related to maintenance and repair.[12] As a practical matter, when TIC interests are held by more than a few owners, satisfying the unanimous vote concept can become extremely onerous.

Enter the master lease. Master leases provide a solution to such restrictive conditions, and they are often used in TIC arrangements as a way to achieve compliance with the Revenue Procedure. For example, TIC owners can lease the rental real estate to a master tenant under a long-term lease, and the master tenant then subleases the property to multiple tenants. Under such a scenario, the TIC owners need only make a single unanimous decision in selecting a master tenant. The master tenant will then manage the project and make leasing decisions, relieving the TIC owners from having to reach unanimous decisions with respect to daily operations. Relegating the management of the project to the master tenant also insulates the TIC owners from being characterized as conducting business activities beyond those that are customary and thus the arrangement from being considered a disqualifying interest in a partnership or other entity.

MASTER LEASES AND REITS

Background on REITs

REITs provide investors with an opportunity to invest in a professionally managed pool of real estate in a tax efficient manner. In general, REITs are organizations that are treated as corporations for U.S. federal tax purposes but receive special tax treatment under the Code that makes these vehicles more tax efficient than traditional subchapter C corporations. They also can be an extremely efficient vehicle for foreign persons to invest in U.S. real estate while mitigating the impact of Sections 897 and 1445 (FIRPTA). The special tax treatment is only available to the extent that a REIT's income is from passive sources and the REIT does not engage in any active trade or business.[13] The tax efficiency is achieved through a REIT's ability to deduct the income distributed out to shareholders, thus eliminating the double taxation typical of corporate income and instead delivering pass-through or conduit treatment to its shareholders. The benefits of the REIT structure, however, come with the added burdens of establishing and maintaining qualification under the REIT rules for U.S. federal income tax purposes. The REIT rules impose complex organizational and structural requirements, income and asset tests, and distribution and record keeping requirements.

In particular, each year, a REIT must satisfy two different income tests, which are designed to ensure that the income derived from the REIT is in fact passive in nature. The first test requires that for each taxable year, at least 95% of a REIT's gross income must be derived from dividends, interest, rents from real property, gains on dispositions of stock, securities, and real property not held for sale to customers in the ordinary course of business, income and gain from foreclosure property, fees received for making mortgage loans and entering into purchase contracts and leases, and certain related items.[14]

The second test requires that in addition to the 95% income test, at least 75% of the REIT's income for a taxable year must be derived from real property investments including rents from real property, interest on real property mortgages, gains on dispositions of real property not held for sale to customers in the ordinary course of business, dividends from other REITs, gains on dispositions of shares of other REITs, income and gain from foreclosure property, refunds of real property taxes, and "qualified temporary investment income."[15]

Rents from Real Property

Both REIT income tests provide that "rents from real property" qualify as "good income" (i.e., income that is included in determining whether the 95% or 75% threshold is met). As discussed below, the Code defines "rents from real property" by describing examples of what is included in the phrase and what is excluded from it. The Treasury Regulations add that "rents from real property" means amounts received "for the use of, or the right to use, real property."[16]

The phrase "rents from real property" is defined to explicitly include "rents from interests in real property" as well as rent attributable to personal property leased with the real property, provided that, the rent attributable to such personal property is 15% or less of the total rent for the year.[17] Charges for customary services rendered in connection with the rental of real property are also included as qualifying "rents from real property," and are thus good income.[18] For example, the provision of utilities would be a customary service that would not disqualify the rent attributable to the leased property from satisfying the annual income tests.[19] Window cleaning, cleaning of common spaces, general maintenance and janitorial services, collection of trash, elevator services, telephone and answering services, incidental storage space, provision of laundry equipment, guard services, parking facilities and swimming pool facilities are all examples of services that are typically viewed as customary.[20] In each case, however, the services must be rendered to the tenants (or for the benefit of the tenants) and must be furnished through an independent contractor (IK) from whom the REIT does not derive any income.[21] The evolution of the REIT rules governing tenant services is beyond the scope of this article, and is nuanced in many ways as a result of various amendments to the Code and IRS interpretation over the years.

Various categories of gross income are explicitly excluded from the definition of "rents from real property" and give rise to "bad income." Amounts that are contingent on the income or profits derived by any person from the use of the property are excluded unless the amounts are based on a fixed percentage of sales or receipts.[22] Rents are also excluded if they are received from a person in which the REIT owns a 10% or greater equity interest.[23] This "related party rent" prohibition looms large in the context of master leases and will be described further below. Finally, rents attributable to impermissible services provided by a REIT to a tenant are also excluded from qualifying "rents from real property."[24] Impermissible services are more than de-minimis services that are furnished or rendered by the REIT to the tenant or the managing or operating of the property by the REIT.[25] Generally, services rendered through an IK or a "taxable REIT subsidiary" ("TRS") do not give rise to impermissible service income. Special rules exist in the context of hotels and healthcare facilities, where significant, non-customary services are routinely provided on the premises. The REIT rules clarify under what circumstances rent from such facilities will be considered "rents from real property" and are important to consider when structuring such arrangements.

REIT MASTER LEASE STRUCTURES

Qualifying Hotels and Healthcare Facilities

In an effort to navigate the rules described above relating to impermissible tenant services and related party rent restrictions, many REITs have implemented master lease structures of various types. These arrangements share a common thread — namely, they convert what otherwise would be prohibited REIT income into more traditional income that meets the definition of "rents from real property" under Section 856(d). For REITs, the objective is to do so in a manner that allows the REIT and its shareholders to enjoy the underlying economics of the property (and its operations) to the greatest extent possible. To the extent this can be achieved, the tax-advantaged REIT structure can be used to hold a wide range of assets. It also allows foreign investors to invest in these properties while minimizing U.S. tax inefficiency and avoiding some of the adverse tax consequences arising under FIRPTA. In this section we will explore a few of the ways in which REITs use master leases.

Many REITs hold hotel properties, as well as nursing and assisted living facilities.[26] The very ability to hold these asset classes within a REIT structure is somewhat novel, since hotels and nursing homes entail a level of services that predominate as compared to the occupancy value provided to "tenants." Simply put, hotel guests are not paying "rents" as such term is defined under the REIT rules. Instead, they are paying for a suite of services that includes a temporary occupancy right.[27]

Prior to 2001, REITs were required to master lease the hotel or assisted living facility to an unrelated tenant. In doing so, the REIT would give up both control of the property as well as some of the key economics. In 2001,[28] Congress enacted an intricate set of provisions making it easier for REITs to keep the business "in house" and retain more direct privity with the party actually operating the asset. Specifically, for assets that meet the definition of "qualified lodging facility" or "qualified health care property,"[29] the Code contains an exception to the related party rent rule for leases of such properties to a TRS so long as they are operated by an "eligible independent contractor" ("EIK") as defined in Section 856(d)(9).[30] A contractor is *independent* as long as it neither owns more than 35% of the REIT nor is 35% of its equity owned by a person who is related directly or indirectly to the REIT. In order to be considered an *eligible* independent contractor, the independent contractor must have been actively engaged in the trade or business of operating or managing either qualified lodging facilities or qualified healthcare facilities for any person unrelated to the TRS at the time it enters into a management contract with the TRS.[31] If the requirements of this exception are met, the rent paid by the TRS to the REIT with respect to a qualified hotel facility or a qualified hospital facility generally will be treated as qualifying "rents from real property" for purposes of both the 95% and 75% annual income tests.

In many modern-day real estate private equity fund structures, the hotel manager is an affiliate of the fund's sponsor. The EIK analysis may become extremely involved and may necessitate substantial restructuring due to the operation of the intricate attribution rules. For example, if a fund or other entity is owned by persons who also own the REIT and the manager, the latter may be disqualified as an EIK.

A typical hotel REIT structure involves a master lease between the REIT (or an operating partnership owned by the REIT) and its TRS. The master lease usually calls for fixed rent plus additional rent based on a percentage of gross revenues.[32] The terms of these leases are usually between two and five years. The TRS enters into a management agreement with an operator to manage the hotel or healthcare facility. The TRS will typically earn a spread, comprised of the difference between its revenue from operations and its management fee expense. Because of limitations on the amount of REIT rents that can be attributable to personal property, it may be necessary in hotel REIT structures for the TRS to take ownership of some of the furniture and other fixtures that constitute personal property.

Negotiating the financing of a hotel REIT can be complex. The primary mortgagor will be the REIT itself, as the owner of the property. However, lenders may seek more direct access to the TRS/lessee as well. There are a number of ways to accomplish this. For example, the TRS may provide a pledge of assets under its master lease with the REIT, which can then "on-pledge" the assets to the lender pursuant to the first mortgage. Some lenders will require the TRS to be a borrower, in addition to the REIT property owner. Others may only require a pledge of the master lease itself. Additionally, when a mezzanine financing is in place, it is not uncommon for lenders to insist on a pledge of the membership interests in a parent entity to the TRS.

It should be noted that the hotel and healthcare facility structure is one of two primary exceptions to the related party rent restrictions applicable to TRSs. Under the "limited rental exception" of Section 856(d)(8)(A), a REIT may receive rent from a TRS if at least 90% of the leased space of the property is leased to persons unrelated to the TRS and the REIT, and the rents paid by the TRS are "substantially comparable" to those paid by such unrelated persons.[33] This exception will be very useful to a REIT that owns real estate that a TRS must access in order to perform tenant services.[34]

Non-qualifying Hotels and Healthcare Facilities & Other "Non-traditional REITs

Master lease structures are also likely to arise in the context of senior living facilities or hotels that do not meet the definition of "qualified lodging facilities" or "qualified health care properties." Section 856(d)(9)(D) provides that a lodging facility includes hotels, motels and any other establishment "more than one-half of the dwelling units in which are used on a transient basis." Under this rule, it is not clear that extended stay suites would qualify.[35] Without the protection of the special exception, REITs that own these assets are unlikely to be able to avoid impermissible services, and may even have trouble concluding that the income they earn is "rent" for tax purposes. In these cases, the REIT may be able to hire an independent third party (or a TRS) to provide all services and have the tenants pay the REIT solely for the occupancy of space.[36] An arguably "cleaner" alternative is to enter into a master lease of the property with an unrelated party that will operate the asset.

Master lease structures for REITs are by no means limited to hotels and nursing facilities. In fact, master leases may be featured in connection with ownership of numerous categories of "nontraditional" REIT assets, or those that would not typically earn quintessentially "rental" income due to significant tenant services or other factors. With respect to parking facilities, for example, a REIT generally cannot derive income from making parking spaces available to third parties unless the REIT master leases the parking garage to an operator pursuant to an arrangement that is respected as a true lease for tax purposes.[37] Master leases to operators can take many forms, but they will usually include percentage rent based on the gross revenue. Energy or infrastructure assets (such as power plants) may be held in a REIT that owns the associated fixed assets, with the lessee/operator earning income from generating the power and selling it off to the grid. Master leases are also found in farmland REITs, where farmers lease crop farmland under triple net leases.[38]

REITs that structure their assets under master leases are clearly giving up some of the operational upside of the business, when compared to a structure in which the tenant services are kept "in house" either through an independent contractor arrangement or a TRS. A 2004 IRS ruling describes a cold storage company that had in place a master lease structure where all properties were leased to an independent lessee/operator under certain long-term master leases. The operator provided food manufacturers, distributors, and retailers with temperature-controlled storage space as well as handling, transportation, and other supply chain services. The company proposed to terminate the master leases and cause its newly formed, wholly-owned TRS to acquire the operator. Thereafter, the logistics services were provided to cold storage customers through one or more TRSs of the company. The IRS approved of the proposed arrangement, finding that the rent the company would receive from leasing the storage space directly to customers would qualify as rent from real property and the fees attributable to services to be performed by the TRS would not be attributed to the company.[39]

For REITs, the most important features of these master leases (aside from their being respected as true leases for tax purposes) is that (1) the rent is good rent for REIT purposes, and (2) the operator is not disqualified as a related party tenant. In many master lease transactions, the property owner/lessor is trying to approximate a joint venture arrangement with the operator whereby the parties share the profits from the operation of the property. This requires carefully structuring the rent terms in a way that meets the "rents from real property" definition. It is commonplace, particularly in retail REITs, for a master lease to provide for fixed rents and percentage rents. While percentage rents based on a tenant's net income or profits is impermissible, rents based on a fixed percentage of gross receipts or sales qualify for REIT purposes.[40] Furthermore, rent can be computed as a percentage of gross sums over a fixed dollar amount, so long as the fixed amount does not change over the term of the lease and is not itself based on net income or profits.[41] While this allows parties to replicate a profit sharing arrangement to some degree, care must be taken not to create what is functionally a net profit-based rent. In particular, building too many reductions into the gross receipts computation increases the risk that the formula will be viewed as a net income-based rent. Customary business practices relating to the computations of gross receipts are taken into account for these purposes.[42]

As a result of these restrictions, an investment in a REIT owning these types of assets will not be economically identical to owning these assets directly and being subject to the business risks of the underlying operations. Instead, the business essentially will be divided into a real estate component and an operating component. To be sure, a percentage rent formula based on gross revenue will cause these two components to be generally aligned. Nonetheless, dislocations could occur if, for example, the expenses of operating the business increase unexpectedly.

Propco/Opco Structures and REIT Spinoffs

In September 2013 the IRS issued the first private letter ruling approving the tax-free spinoff of a standalone REIT by a C corporation.[43] This ruling, issued to Penn National Gaming, Inc., ("PNG") was groundbreaking for a number of reasons, primarily relating to various requirements under Section 355, such as the "business purpose," "device" and "active trade or business" requirements. The property company ("Propco"), a REIT spun off from PNG ("GLPI"), held the casino and gaming real estate and triple net leased the properties under a 35-year master lease agreement (including extensions) to an operating company ("Opco") affiliate. An interesting element of the PNG transaction was that a couple of significant shareholders that owned in excess of 10% of the company were required to sell or restructure their interests in the companies in order to avoid a related party rent problem under Section 856.[44]

After Penn National's REIT spinoff, other companies in varying industries consummated similar transactions. For example, the Ensign Group Inc. in June 2014 spun off CareTrust REIT Inc., which holds Ensign's skilled nursing, assisted living, and independent living properties. CareTrust entered into an Propco/Opco lease with Ensign and elected to be a REIT.[45] Also in 2014, CBS Corp. split off its outdoor ad business, CBS Outdoor Americas Inc., which later changed its name to Outfront Media Inc.[46] Other companies such as Windstream Holdings Inc., Caesar's Entertainment Corporation and Hilton Worldwide Inc. soon followed suit.[47] While recent legislation has shut down the tax-free REIT spinoff,[48] variations of this "Propco/Opco" structure remain viable, and, like PNG, utilize master leases. For instance, Sears Holding Corp. completed a *taxable* spinoff of Seritage Growth Properties in July of 2015.[49]

One taxpayer deployed a "captive REIT" variation of the REIT spin-off in order to monetize its real estate portfolio. In particular, in 2016, publicly traded hospitality company MGM Resorts International (MGM) contributed seven large Las Vegas resort properties and three gambling casinos to a newly formed REIT, which then leased the property back to a subsidiary of MGM pursuant to a master triple-net lease.[50]

The master lease provides for an initial lease term of 10 years with the potential to extend for four additional five-year terms. It also requires the tenant, the MGM subsidiary, to pay substantially all costs associated with each property (including real estate taxes, insurance, utilities and routine maintenance) and rent. The rent was comprised 90% of base rent, which is subject to an annual fixed rent escalator of two percent until 2022, and 10% of percentage rent, which will be fixed for the first six years, and will then be adjusted every five years based on the average annual net revenues of the MGM subsidiary and any subtenants. It also provides the REIT with a right of first offer with respect to a few of MGM's other key development properties.[51]

All these PropCo/OpCo transactions share a basic feature in that they rely on large master lease arrangements and do so in a way that navigates the REIT rules governing rents from real property. The master lease structure allows for the lessees to make tax-deductible rent payments in exchange for the right to use the PropCo's facilities. The rental income is not subject to corporate tax as long as PropCo qualifies as a REIT and distributes the income to its shareholders. In this way, these taxpayers have been able to creatively make use of the REIT regime and the master lease structure to deliver value to shareholders in a tax-efficient manner.

True Lease Analysis

As the above discussion makes clear, the lynchpin of the master lease structure for REITs is the qualification of the master lease itself as a "true lease" for U.S. federal income tax purposes. Since the stakes for REITs are so significant (namely, the very qualification of the property owner as a REIT), public disclosure will typically describe the risk that the leases will not be respected.[52] Furthermore, REITs will typically seek opinions of counsel that specifically address the treatment of the lease, even when the REIT otherwise receives a qualifying REIT opinion.[53]

Historically, much of the caselaw and guidance in the lease area has emerged from sale-leaseback transactions, when the relevant question is whether the nominal buyer/lessor is respected as the tax owner of the property or alternatively whether the transaction is simply a disguised financing.[54] In master lease structures, the analysis is somewhat more nuanced, since the REIT is likely to be respected as the owner of the property. Instead, the relevant question is whether the relationship with the operator is respected as a lease or instead recast as a service or management contract, or joint venture.

According to the U.S. Tax Court, the two primary factors that indicate the existence of a management contract (as opposed to a lease) are (1) control of the venture by the property owner, and (2) risk of loss on the property owner.[55] Section 7701(e) provides, somewhat tautologically, that "a contract which purports to be a service contract shall be treated as a lease of property if such contract is properly treated as a lease of property, taking into account all relevant factors." The provision then enumerates various factors that are relevant in the determination, including whether or not (a) the service recipient is in physical possession of the property, (b) the service recipient controls the property,(c) the service recipient has a significant economic or possessory interest in the property, (d) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract, (e) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and (f) the total contract price does not substantially exceed the rental value of the property for the contract period.

Legislative history and caselaw suggests that the "control" and "risk of loss" factors are the most important.[56] Specifically, the "true lease" inquiry hones in on the degree of control exercised by the nominal lessor in order to determine whether the relationship between the parties is disguised as a lease but is really one of principal and agent. Certain economic terms should be avoided. For example, if the tenant is only required to pay rent if its use of the property results in true profit, that would be indicative of a management arrangement and not a genuine lease. In a true lease, the lessee has no recourse in the event operating expenses exceed the amounts that it is entitled to retain. The landlord's absolute ability to terminate the tenant's right to possess the property, or the ability to sell interests in the property without tenant's consent, is also indicative of a management arrangement and not a lease.[57]

A complete discussion of the true lease analysis is beyond the scope of this article, but it is important to note that subtle economic features of these transactions can greatly impact the analysis.[58] Tax advisors must focus on contractual terms such as insurance requirements, record-keeping obligations, tenant financing rights, and casualty losses. Therefore, great care is needed in drafting master leases to ensure that the intended tax treatment is achieved, especially in the high-stakes world of REITs.

MASTER LEASES AS CREDIT SUPPORT

In addition to their use in TIC and REIT-structuring transactions, master leases may be used as a credit-support tool in commercial real estate transactions. Although a master lease structure allows significant creativity to the parties in deal-making and overcoming transactional obstacles, a master lease structure is just one of a number of credit-support tools and should be analyzed in light of all available options.

For purposes of this discussion, a master lease is a lease of rentable space in a commercial real estate asset that is structured to provide a predictable stream of rental payments over a defined term to support the economic performance of the asset but the master tenant usually does not have the right to occupy the premises. Generally, the tenant will master lease the entire premises; however, in certain cases, the tenant may master lease a portion of the total space.[59] Most frequently, master leases are used to provide assurances to the owner of a real estate asset or its lender or both that the asset has "sufficient" rents (or projected rents) to enable the counterparty to move forward with a transaction—whether it be increasing the net operating income of an existing asset or mitigating risk in a development transaction.

EXAMPLE USES OF MASTER LEASES

As a creature of contract, master leases may afford significant transactional flexibility. Examples of master lease structures as credit support include:

Bridging a Gap in Net Operating Income in a Financing Transaction

A buyer desires to acquire a vacant office building. The sponsor may possess expertise in owning and managing office buildings, but the ownership group may contain investors that are not willing to invest in a speculative asset. In such a circumstance, the sponsor or one of its affiliates would master lease the building. The master lease would permit subleases and even direct leases with the owner to sub-tenants that would occupy the premises. The sponsor/master tenant subleases space to office tenants, providing the owner with a predictable income stream and reduced operating risk and permitting the sponsor/master tenant to maximize sublease value and retain profits in excess of rent and other payments.[60],[61]

Bridging a Gap in Net Operating Income in a Sale Transaction

A seller desires to sell a retail shopping center but the center has insufficient net operating income (as analyzed by the buyer and/or its lender) to support the seller's required price or the required amount of debt proceeds or both. In such a circumstance, the seller or one of its credit-worthy affiliates might enter into a master lease on a vacant space for a defined period of time, perhaps placing the rent in escrow or providing a letter of credit, thus increasing the net operating income until the vacant space is let to an acceptable tenant (as discussed below).[62]

Bridging a Revenue Gap in a Development Transaction

A hospital desires to increase the amount of medical office building space on its hospital campus. The developer and lender require the hospital or one of its credit-worthy affiliates to master lease the entire premises for a minimum cash flow to underpin the financial capacity of the project and reduce the speculative nature of the development. When the hospital finds an acceptable medical practice or related provider, the master lease would provide that such tenant may enter into a new lease with the landlord (with the result that the hospital's obligations under the master lease would burn off in part). In such a lease, the burn-down provision and the conditions to its burn-off should be carefully negotiated — especially relating to the lease term, any required economic terms of a sublease (such as minimum rent, minimum term, tenant concessions and build-out costs), any required characteristics of the sub-tenant (including credit-worthiness) and any use or tenant mix restrictions.

Structuring Considerations

Similar to any lease, the landlord's (and its lender's) underwriting of a master lease would be expected to include the identity and credit of the tenant, the tenant's permitted use of the space and the tenant's source of funds for rental payments; however, a master lease may be riskier than a typical third party space lease because the master tenant does not rely on the premises for its business operations and therefore is not compelled to pay rent.

From a landlord's perspective, master leases carry at least two additional risks — the bankruptcy of the master tenant and a potential re-characterization of the master lease as a guaranty.

Tenant Bankruptcy

Generally, the U.S. Bankruptcy Code enables insolvent debtors to reorganize in a manner that enables them to continue as ongoing enterprises. During the pendency of the bankruptcy case, a tenant has a number of significant rights that could affect the landlord's rights under the master lease, including the imposition of the automatic stay after a bankruptcy filing (which prevents a creditor such as a landlord from attempting to collect its outstanding debts against the tenant during the bankruptcy (including the right to receive rents)) and the right to assume or reject real property leases.[63]

In a bankruptcy proceeding, rent that accrues but is not paid prior to the bankruptcy filing is a general claim against the bankruptcy estate. After the bankruptcy filing, a landlord has an administrative claim for the period the tenant occupies the premises from the date of bankruptcy through the date on which the lease is rejected and a general unsecured claim limited to the greater of one year's rent reserved under the lease or 15% of the rent reserved for the remaining term of the lease (not to exceed three years of rent).[64] The time delay associated with a potential bankruptcy filing as well as the potential caps on rental payments and potential status as an unsecured creditor if the tenant rejects the lease each conflict with the credit support purpose of the master lease.

Re-characterization of the Master Lease as Guaranty

As described in this Section III, a master lease is typically used as a credit support mechanism in which the tenant is required to pay rent to the landlord for property that it does not occupy. A payment guaranty — absent the creation of an interest in real estate — is similar, as the guarantor is required to make payments to the holder of the guaranty as a matter of contract.

Accordingly, if a tenant defaults under a master lease, the landlord or tenant may attempt to characterize the lease as a guaranty. However, unlike well-drafted guarantees, it would be unlikely for a master lease to contain waivers of suretyship defenses, such as the obligation of the holder of the guaranty to mitigate damages and first exhaust recovery from other sources. Thus, if the tenant files for bankruptcy, the landlord may attempt to re-characterize the master lease as a guaranty to avoid a potential rejection of the master lease and the caps on recovery. In other contexts, the tenant may attempt to re-characterize the master lease as a guaranty in which the tenant has retained its suretyship defenses, or the landlord may attempt to re-characterize the master lease to avoid a tenant's rights as a tenant under state property law, each injecting uncertainty into the intended economic relationship between landlord and master tenant.[65]

Alternative (or Additional) Forms of Credit Support

A number of alternative types of credit support may be preferable to, or used in conjunction with, a master lease structure. Properly drafted payment and performance guarantees from a credit-worthy guarantor (with waivers of suretyship defenses) may support the income of a real estate asset yet avoid the creation of a landlord-tenant relationship. Similarly, cash escrows, holdback and standby letters of credit may provide alternative or additional methods to support real estate transactions.[66]

CONCLUSION

The flexibility of a master lease structure may help parties to consummate commercial real estate transactions by providing a mechanism to underpin the financial results of a real estate project; however, a number of legal and practical considerations must be evaluated.

While we have attempted in this paper to give the reader a general summary of relevant materials, each reader is advised to independently evaluate the applicability of the concepts described in this paper to any specific circumstance with the assistance of qualified counsel.

Notes

1 Unless otherwise noted, all "Section" references herein are to the Code.

2 Disclaimer: this article is intended to describe background principles in general terms. It does not, and is not intended to, provide legal, tax or regulatory advice and is not permitted to be relied upon by any party for any purpose. Readers should consult their legal and tax counsel and other advisers when analyzing any topic discussed herein.

3 Section 1031(a). Despite indications that Section 1031 was in danger of repeal, recent tax reform proposals have retained Section 1031 benefits, at least for real estate.

4 Teruya Bros., Ltd. v. Commissioner, 580 F.3d 1042 ,1038 9)th Cir. 2009).

5 Section 1031(a)(1).

6 Section 1031(a)(3).

7 Section 1031(a)(2) ,(1); Treas. Reg. § 1.1031(a)1-(a).

8 Section 761(a).

9 See Bartell's Est. v. Commissioner, 147 TC 2016) 161 ,140).

10 Treas. Reg. § 1-301.7701(a)(2) (partnership exists if co-owners of an apartment building lease space and, in addition, provide services to the occupants either directly or through an agent); Tim H. Cusick, 76 TC Memo 286-1998 (co-owners of rental real estate were partners despite never having filed partnership tax returns and the lack of a formal partnership agreement, where facts indicated the intent of parties, sharing of income and expenses, and business activity indicated the parties were properly characterized as partners in a partnership for tax purposes).

11 Rev. Proc. 1-2002 ,22-2002 C.B. 733 (the "Revenue Procedure").

12 Id. at § 6.

13 H.R. Rep. No. 86 ,2020th Cong., 2d. Sess., at -1960 ,(1960 4 2 C.B. 119.

14 Sections 856(c)(856 ;(2(c)(5)(J)(ii).

15 Sections 856(c)(856 ;(3(c)(5)(J)(ii).

16 Treas. Reg. § 4-1.856(a)(1).

17 Section 856(d)(1)(C).

18 Section 856(d)(1)(B).

19 Treas. Reg. § 4-1.856(b)(1).

20 Treas. Reg. § 4-1.856(b)(1).

21 Treas. Reg. § 4-1.856(b)(1).

22 Section 865(d)(2)(A). The gross receipts rule is discussed in further detail below

23 Section 856(d)(2)(B). The attribution rules of Section 318(a), as modified by Section 856(d)(5), apply in determining whether the requisite ownership percentage is met.

24 Section 856(d)(2)(C).

25 Section 856(d)(7).

26 The first lodging REIT went public in 1993, and many have followed.

27 See, e.g., PLR 9550019.

28 These provisions were part of the same legislative package that introduced TRSs to the tax law. See H.R. 1180, the Work Incentives Improvement Act of 1999, which contained the REIT Modernization Act. This legislation enabled nearly all REIT to form TRSs to perform substantial services to tenants. The advent of TRSs was one of the most dramatic developments and innovations in the history of the taxation of REITs. *See* Sections 71-541 of Pub. L. No. -106 170, the Ticket to Work and Work Incentives Improvement Act of 1999. Qualified health care properties were added to this regime in 2008 by Pub. L. No. 289-110.

29 A hotel will generally be a qualified lodging facility so long as no gambling occurs on premises. Nursing and assisted living facilities typically are "qualified health care properties," which are defined to include a "hospital,

nursing facility, assisted living facility, congregate care facility, qualified continuing care facility… or other licensed facility which extends medical or nursing or ancillary services to patients.” *See* Section 856(e)(6)(D)(ii).

30 Section 856(d)(8)(B). Section 856(d)(8)(A) contains a different exception (the “limited rental exception”) which has proven useful for REITs and their TRSs. That exception is discussed briefly below.

31 Section 856(d)(9)(A).

32 Rent based on net income is not permitted under the REIT rules.

33 The other major exception allowing for a REIT to earn rents from a TRS relates to the operation of hotel and healthcare assets, described below.

34 See, e,g., PLR 201503010 (Jan. 2015 ,16) (payments by TRS to REIT that owned storage facility for the rental of space needed to perform tenant services qualifies for the limited rental exception, even though the space is different than that rented by the REIT’s storage customers, since the rental payments “will be arm›s-length and will be substantially comparable to rents paid by unrelated tenants for comparable space located in the same geographic area”).

35 IRS guidance in other areas suggests that what constitutes “transient” for these purposes would be stays of thirty days or less.

36 PLR 200813005 involves a REIT that opted to hire a TRS or independent contractor to provide services instead of master leasing the property to an operator on a long-term basis.

37 In PLR 201628020, the IRS gave a favorable ruling to a REIT that rented parking space to a third-party owner of an adjacent building under a long-term lease. This ruling as significant because it was the first time that the IRS ruled favorably for a REIT that leased some (but not all) parking spaces in a garage.

38 See, e.g., Farmland Partners Inc., Prospectus as filed with the Securities and Exchange Commission (July 24,2014) (“We have leased, and intend to continue to lease, substantially all of our properties under leases with terms ranging from one to five years and pursuant to which the tenant is responsible for substantially all of the operating expenses related to the property, including taxes, maintenance, water usage and crop insurance…”), available at: https://www.sec.gov/Archives/edgar/data/000104746914006407/1591670/a2220909z424b4.htm.

39 *See* PLR 200428019 (March 2004 ,25).

40 Section 856(d)(2)(A).

41 Treas. Reg. § 4-1.856(b)(3). The regulations allow for gross sales to be reduced by other adjustments as well, including “escalation receipts” between a prime tenant and its subtenants.

42 *Id. See also* PLR 201108009 (Feb. 2011 ,25).

43 PLR 201337007.

44 Under Section 318(a)(3)(C), a corporation is considered to own the stock owned by any shareholder who owns, directly or indirectly, more than %50 of the value of that corporation›s stock. However, for purposes of determining whether rent qualifies as rents from real property, a %10 threshold is used. Without the shareholder restructuring, the Propco would have been treated as owning in excess of %10 of its tenant, the Opco, thereby disqualifying the master lease rents under the REIT rules.

45 See CareTrust REIT, Inc. Prospectus as filed with the Securities and Exchange Commission (Sept. 2014 ,11), available at: https://www.sec.gov/Archives/edgar/data/000119312514232653/1579877/d735547ds4.htm.

46 See CBS Outdoor Americas Inc. Form S4- as filed with the Securities and Exchange Commission (June ,11 2014), available at: https://www.sec.gov/Archives/edgar/data/000119312514232653/1579877/d735547ds4.htm.

47 See, e.g., Communications Sales & Leasing, Inc. Form S11- as filed with the Securities and Exchange Commission (June 2015 ,25), available at: https://www.sec.gov/Archives/edgar/data/000104746915005775/1620280/a2225209zs11-.htm#de40501_the_spin-off_and_related_transactions.

48 See Section 355(h); 856(c)(8), both enacted in 2015.

49 See Seritage Growth Properties Prospectus as filed with the Securities and Exchange Commission (June ,9 2015), available at: https://www.sec.gov/Archives/edgar/data/000119312515219435/1628063/d836914d424b3.htm#toc.

50 MGM Growth Properties LLC, Amendment 3. to Form S11- as filed with the Securities and Exchange Commission (April 2016 ,8), available at: https://www.sec.gov/Archives/edgar/data/000119312516534556/1656936/d63051ds11a.htm#toc1_63051.

51 In September 2017, MGM announced that the REIT will purchase the National Harbor property, which will be added to the master lease when the sale closes at the end of 2017. Press Release, MGM Resorts International And MGM Growth Properties LLC Announce Transaction On MGM National Harbor Casino Resort (Sept. 2017 ,5), available at: http://mgmresorts.investorroom.com/-2017-05-09MGM-Resorts-International-And-MGM-Growth-Properties-LLC-Announce-Transaction-On-MGM-National-Harbor-Casino-Resort.

52 See, e.g., Gaming and Leisure Properties Inc., Annual Report (Form -10K), at 23 (Mar. 2014 ,25) («Rents received or accrued by GLPI from Penn or its subsidiaries will not be treated as qualifying rent for purposes of these requirements if the Master Lease is not respected as a true lease for U.S. federal income tax purposes and is instead treated as a service contract, joint venture or some other type of arrangement. If the Master Lease is not respected as a true lease for U.S. federal income tax purposes, GLPI may fail to qualify to be taxed as a REIT”).

53 In some cases, the REIT opinion may explicitly rely on the conclusions reached in the true lease opinion.

54 See, e.g., Frank Lyon Co. v. United States, 435 U.S. 561 1978)); American Realty Trust v. United States, 498 F.2d 4) 1194th Cir. 1974).

55 Amerco v. Commissioner, 82 T.C. 1984) 654). See also PLR 199940040 (July 1999 ,13).

56 H.R. Rep. No. 432 (Part 98 ,(2th Cong., 2nd Sess. 1156-1152 1984)). See also Thomas R. Meagher, TC Memo 270-1977, August 1977 ,15.

57 PLR 201525007 (June 2015 ,9).

58 See Amerco, 82 T.C. 654 at 673 ("At first glance, one might think that our analysis and ultimate decision in Meagher would compel a decision in respondent›s favor in the instant case…However, the inquiry is inherently factual, and differences in the rights and duties of the parties may tip the scale in the opposite direction.").

59 Ground leases, sale/leaseback and credit tenant lease transactions can each be seen as a "master lease" structure; however, they are beyond the scope of this paper. A ground lease is a long-term lease by a master tenant of the land, paired with the tenant's fee ownership of the improvements on the land. The ground lessee acquires the improvements and pays rent to the fee owner for the land for the term of the lease. Upon the expiration of the term, the ground lease is terminated and the improvements revert to the fee owner. In a sale-leaseback, the owner and occupant of a real estate project generally desires to redeploy its capital by selling the project and entering into a long-term lease for the right to occupy the project for a specific term, thereby enabling the tenant to receive an influx of capital on the sale of the asset, potentially eliminate debt from its balance sheet and deduct its rent payments (see generally Rick Thomas, Pratt's Journal of Bankruptcy Law, Volume 9, Issue 6 (September 2013), Cross-Defaulted Leases in Bankruptcy: Integrated or Severable Agreements? A credit-tenant lease is a lease for an entire project from a credit-worthy tenant. Under the National Association of Insurance Commissioners guidelines, if a tenant is sufficiently credit-worthy and the lease contains sufficient impediments to termination by the tenant, the insurance company is permitted to a lower capital reserve requirement are reduced when compared to a commercial real estate loan, as the lender looks to the "credit tenant" for repayment as if the loan were a corporate bond rather than a secured real estate loan. See National Association of Insurance Commissioners' Model Laws, Regulations, and Guidelines, available at: http://www.naic.org/prod_serv_model_laws.htm.

60 See Edward J. Hannon, Real Estate Loan Workouts and Restructurings for Tenant in Common Owners, Freeborn & Peters LLP, copyright 2013-2012, available at: https://www.freeborn.com/assets/white_papers/freeborn_peters_white_paper-tic_workouts-2013-edward_hannon-_0.pdf.

61 See also Cheryl P. Armata, Lender Concerns About Master Leases, 24 No. 2 Prac. Real Est. Law. 59, March 2008.

62 For a general discussion, see Douglas P. Snyder, Master Leases in Financing Transactions, Real Property Trust & Estate Law, December 2006. See also 2 Illinois Real Property §12:17, Effect of Master Lease, copyright 2017. See also Douglas P. Snyder, Master Plans, Commercial Investment Real Estate Magazine, available at: https://www.ccim.com/cire-magazine/articles/master-plans/?gmSsoPc=1.

63 11 U.S.C. §365. If a lease is assumed in a bankruptcy proceeding, the debtor must cure any defaults and provide adequate assurance of future lease obligations.

64 11 U.S.C. §502(b)(6).

65 *See* Gregory G. Gosfield, Esq. and Kathleen Torbit, Esq., *The Structure and Use of Real Estate Guaranties and Sureties*, 2010-2009, available at: http://klehr.com/C7756B/assets/files/lawarticles/GGosfieldCLEdoc.pdf. *See also* Anthony J. Jacob, Aric T. Stienessen and Jeremy D. Duffy, *Enforcing the Commercial Guaranty Agreement*, Hinshaw & Culbertson LLP, available at: http://apps.americanbar.org/buslaw/blt/content/0003/01/2012a.pdf. An example of re-characterization can be found in a sale/leaseback transaction. If the seller/lessee files bankruptcy, the bankruptcy estate may attempt to re-characterize the sale/leaseback as a mortgage, on the grounds that the lessee, as the holder of a long-term tenancy right and a right to purchase the fee, is economically equivalent to an owner of the fee interest subject to a mortgage (the obligation to make debt payments). A landlord is likely in a better position in a bankruptcy than a mortgagee. In a bankruptcy proceeding, if a tenant assumes a lease, the tenant must cure defaults provide adequate assurance of performance of future obligations under the lease, whereas, a secured creditor may have the terms of its mortgage modified by the bankruptcy court so long as it receives payments with a present value equal to the value of its interest in the collateral, as determined by the court. See generally Marshall E. Tracht, *Leasehold Recharacterization in Bankruptcy: A Review and Critique*, New York Law School Legal Studies, Research Paper Series 2013) 42# 13/12).

66 *See* Gosfield et al., page 57.

CHECKLIST FOR LETTER OF INTENT AND LEASE NEGOTIATIONS (WITH SAMPLE PROVISIONS)

IRYNA LOMAGA CAREY is a partner in the real estate department of Kurzman Eisenberg Corbin & Lever, LLP, in White Plains, New York. Her practice focuses on commercial real estate transactions including, commercial sales & acquisitions, joint ventures, commercial leasing and commercial finance. She has broad based experience in retail/industrial/office property leasing and acquisitions; operating company acquisitions and dispositions; negotiation of construction contracts; and financing and construction of a broad range of commercial properties. Ms. Carey has represented landlords and tenants in enclosed malls, strip centers, warehouse/industrial projects and pad sites. She has extensive experience handling due diligence in connection with significant real estate acquisitions of both real property and debt portfolios.

This summary is intended to be a checklist of items that landlords and tenants should consider in connection with the review and negotiation of a letter of intent and the ultimate negotiation of a lease. It is not intended to be a complete discussion of all possible considerations, but should be considered a guide.

PREMISES AND SHOPPING CENTER/BUILDING

- Size of premises (dimensions, frontage, leasable vs. rentable square footage)
- Review how landlord calculates the size (inclusive of columns, exterior areas, etc.)
- Obtain a schematic of premises
- Re-measurement right (important if landlord is demising space)
- Inspection of premises by contractor to determine if MEP and HVAC are in good working order and whether systems have sufficient capacity for use (important if tenant is to take on any repair obligations)
- Review plan for shopping center for access issues and visibility issues
- Pro rata or proportionate share—make sure you know how it is calculated, particularly the denominator
- Make sure that the denominator is as large as possible and limit landlord's exclusions form the denominator (e.g., office space, outparcels, vacant space, anchor tenants, basement space, etc.)

USE AND OPERATION

- Should be as broad as possible (include "any retail purposes not in conflict with exclusive of another tenant")
- Check local requirements for use permits
- Exclusive protection—to protect your investment, seek an exclusive for your use
- Special rights—roof access, dumpster access, handicapped accessibility
- Ability to install satellite dish or other communication systems
- Building signage rights—conform to shopping center standard or can you use your own logos?
- Pylon/monument—size of panel, location, maintenance issues
- Window signage—limit prohibitions on signage you can install on storefront windows and doors
- Check signage criteria before you order signs
- Check local ordinances for signage requirements and limitations
- Check local ordinances for signage requirements and limitations

- Check local ordinances for restrictions on operation (no Sundays, etc.)

TERM

- Initial term—how long? Too long means you may not have an exit strategy
- Commencement of term—upon delivery, upon completion of landlord's work, time for completion of your improvements—need to be very specific
- Landlord's failure to deliver—negotiate a drop-dead date for delivery if important to the success of your business
- Renewal term—notice period for exercise of option to renew, rent for renewal
- Expiration—last day of the month or middle of the month
- Check for requirements for surrender—turnover of keys, premises etc. to avoid being considered a holdover
- Early access—if landlord is doing some fit-out work for you, ask for early access to begin measurements, store FF&E and begin workConsider kick-out rights if space does not work (typically based upon the gross sales generated in the space)
- Exit strategy—broad assignment/sublet rights and kick-out if possible; ensure that you can sell your business (via an asset or stock sale) and transfer the lease freely without landlord's consent

RENT

- Gross rent—you pay no extras for taxes, operating expenses or insurance, all of those charges are built into your rent
- Net rent—you pay rent and your share of taxes, operating expenses and insurance so that landlord recovers 100 percent of costs
- Free rent—means that you can occupy and operate in the premises without the obligation to pay rent; this is very different form a build-out period during which you can build out the space and not pay rent, as there is nothing "free" about a build-out period if you will commence payment of rent immediately when location opens for business
- Percentage rent—landlord receives a fixed percentage of your gross sales over an agreed upon breakpoint (natural breakpoint is the number derived from dividing the annual rent by the percentage landlord is to receive)
- Gross sales—need to be negotiated; carefully review landlord's proposed language and exclude all items that affect your bottom line
- Security deposit should not exceed two months fixed rent (if landlord demands more, try to get one month released after first 12 months if you have paid timely)
- First month's rent due on execution of lease is typical

OPERATING EXPENSES OR CAM

- Carefully review what is included in operating expense definition or CAM
- Exclude capital expenditures
- Landlord should be responsible for roof and structure
- Consider seeking a cap on operating expenses or CAM
- Cap typically does not apply to uncontrollable expenses (snow removal, insurance and utilities)
- Administrative fee—typically 10-15 percent of expenses
- Management fee—typically three to five percent of rents collected
- Landlord should not collect both administrative fee and management fee
- Make sure administrative fee does not apply to taxes, insurance or utilities (no reason for landlord to get a bonus on those expenses, as they are pass-through expenses)
- Need right to audit landlord's records

- Taxes—exclude special assessments, profits, franchise and inheritance taxes
- Consider requesting audit right and right to seek reimbursement for cost of audit if there is a mistake found in landlord's books and records
- Look closely at whether you are subsidizing anchor tenants that don't pay their share
- Check out the shopping center generally for condition to anticipate large repairs in the future and ask the landlord for last year's operating expense/CAM reconciliation

REPAIRS AND COMPLIANCE

- Limit your repair obligations to non-structural, interior of premises (do not let landlord extend repair rights to sidewalk, adjacent areas, etc. Should be limited to just those areas that you exclusively use, unless you cause damage)
- Note—before agreeing to any scope of repair, make sure the premises was inspected, as noted above
- Where do your obligations for utilities begin? Point of connection?
- Is premises sub-metered for utilities? If not, who pays for meter installation?
- Landlord—responsible for roof and structure, at its sole cost and expense
- Important to clarify what repair and replacement costs can be passed through to you as part of operating expenses or CAM and what is landlord's responsibility
- Make sure to distinguish "repair" from "replacement"
- You do not want to be in the position of making costly replacements to capital equipment like HVAC units during the last year of the term, thus giving the landlord the benefit of the useful life
- Compliance—should be limited to your particular manner of use, not retail use generally; landlord should be responsible for repairs necessitated by ADA and other compliance if repair applies to all tenants of the shopping center
- Visibility and access—make sure that landlord agrees to use commercially reasonable efforts to not materially or adversely affect visibility or access to the premises in connection with its use of the common areas or compliance with its repair obligations

MISCELLANEOUS

- Estoppels—at least 20 days to provide, specify what estoppel should say, do not let landlord act as your attorney in fact
- SNDA (subordination, non-disturbance and attornment agreement)—nice to have but not necessary unless you are investing a large sum into the premises for improvements
- Assignment & Sublet—limit landlord's control and approval rights; ensure you can sell the business without interference
- Casualty/condemnation—most important is to ensure that you can terminate if repair takes too long or use and enjoyment of the premises (access, visibility, etc.) are materially or adversely affected
- Alterations— you should be able to make interior, non-structural alterations without landlord consent or approval
- Make sure you are clear about what alterations remain at the end of the term and what the landlord expects you to remove
- Look at the submissions required for alterations, sometimes they are very onerous and can adversely impact the timetable for completion
- Insurance—to be safe, send landlord's proposed insurance provisions to your insurance consultant for review
- Default—try to get notice and cure before default kicks in
- Interest and late charge—late charge to apply only after second late payment in any 12-month period
- Landlord's lien—many states have a statutory landlord's lien which can be imposed on your

FF&E and inventory; if you have expensive FF&E and/or inventory, see if that can be waived

SAMPLE COMMERCIAL LEASE PROVISIONS

Delivery

Landlord agrees to deliver the Premises to Tenant in vacant and "broom-clean" condition, free of all tenancies and occupancies and in compliance with all applicable laws. If for any reason Landlord is unable to give Tenant possession of the Premises by ______________, Tenant may terminate this Lease upon five (5) days' written notice to Landlord, and if Tenant so elects to terminate this Lease, all sums paid by Tenant hereunder shall be returned to Tenant immediately.

Compliance with Law

Tenant shall not be required to comply with any statute, law, order, ordinance, code, rule, regulation or requirement of any governmental or quasi-governmental authority, agency, bureau, body, department or official (or, if applicable, the Board of Fire Underwriters) ["Legal Requirement"], such compliance arises out of: (i) Tenant's specific or particular manner of use of the Premises (as distinguished from Tenant's mere use of the Premises in accordance with the provisions of this Lease); or (ii) the negligence or willful misconduct of Tenant. Tenant shall have the right to contest, in whole or in part, the legality or applicability of any present or future statute, ordinance, rule, order, law, code, regulation or requirement with which Tenant must comply, by appropriate legal proceedings.

Services

If any services supplied by Landlord hereunder are interrupted, suspended or curtailed, Landlord agrees to use due diligence and its best efforts to restore such services as promptly as possible. If Tenant's ability to make normal use of the Premises is interrupted for more than five (5) consecutive business days due to any act or omission of Landlord or any of its agents, servants, employees, contractors, licensees or invitees, the next installment(s) of rent and additional rent due under this Lease shall be reduced on a per diem basis for each full or partial day of such interruption.

Self Help

If Landlord fails to make any repairs or do any work required of Landlord in accordance with the provisions of this Lease, or if Landlord shall at any time be in default in the observance or performance of any of the other terms, covenants, conditions, provisions and agreements required to be performed and observed by Landlord hereunder, and any such failure or default continues for a period of ten (10) days after notice thereof is given by Tenant to Landlord, or, if such failure or default requires more than ten (10) days to cure in the exercise of due diligence, unless Landlord commences to cure same within said ten (10) day period and thereafter diligently prosecutes the same to completion, then Tenant, in addition to such other rights and remedies as may be available under this Lease, or at law or in equity, may, but shall not be obligated to, make such repairs or perform such work in accordance with the provisions of this Lease on behalf and at the expense of Landlord, which expenses shall be promptly reimbursed by Landlord to Tenant upon demand therefor.

Interference

Landlord shall use commercially reasonable efforts to minimize interference with Tenant's business in connection with any repair, replacement, improvement and/or work which Landlord is obligated to perform or desires to perform, in and to the Premises, or in connection with any inspection or showing thereof, or entry therein by Landlord as permitted by this Lease.

Alterations

Tenant may make: (i) non-structural alterations, improvements and additions; and (ii) decorative/cosmetic changes, in and to the Premises, without Landlord's prior written consent, provided that Tenant complies with all applicable laws.

Force Majeure

Tenant shall not be deemed in default in the performance of any obligation or undertaking provided herein in the event and/or so long as the performance of any such obligation is prevented or delayed, by Act of God, fire, earthquake, floods, explosion, action of the elements, war, hostilities, invasion, insurrection, riot, mob violence, sabotage, inability to procure or general shortage of labor equipment, facilities, materials or supplies in the open market, failure of transportation, strikes, lockouts, action of labor unions, condemnation, requisition, laws, orders of government or civil or military or naval authorities, or any other cause, whether similar or dissimilar to the foregoing, not within the reasonable control of Tenant.

Landlord's Insurance

Landlord agrees to maintain: (i) fire and extended insurance on an "all-risk" basis on the Building, in an amount equal to not less than the full replacement cost thereof; and (ii) commercial general liability insurance for personal injury and property damage in commercially reasonable amounts, as reasonably determined by Landlord.

Landlord's Work

Landlord shall perform Landlord's work in a good and workmanlike manner in accordance with all applicable laws, and shall obtain and deliver to Tenant all "sign offs" and approvals in connection therewith, including, without limitation, a certificate of occupancy.

Landlord's Repairs

Landlord shall make all repairs to the Premises and be responsible for all damages incurred by Tenant as a result of the neglect, act or omission of Landlord, or its agents, servants, employees, contractors, licensees or invitees.

Landlord's Representations:

- Landlord has received no notice of any violations affecting the Premises or the Building, and Landlord has no knowledge of any condition which, with the giving of notice and the passage of time, would constitute a violation, and Tenant shall not be responsible for any violations against the Premises, nor against the Building as of the commencement of the term of this Lease, whether or not of record.

- The Premises and the Building comply with all applicable zoning, environmental, fire codes and other federal, state and local rules, regulations, laws, statutes and ordinances, as of the date of this Lease, including, without limitation, The Americans with Disabilities Act.

- The certificate of occupancy issued for the Building permits Tenant to use the Premises for the purposes permitted under this Lease.

- All Building systems (including, but not limited to, electrical, mechanical, plumbing, heat, ventilation, air conditioning, sprinkler and life safety) and other facilities and services which Landlord is obligated to provide to Tenant under this Lease, are installed, and in good working order and condition as of the date hereof.

- All utilities and meters therefor have been installed in the Premises, and are in good working order and condition as of the date hereof.

Adjacent Space

[1]Tenant shall have the right of first offer on any adjacent space in the Building contiguous to the Premises, upon all of the same terms, covenants, conditions, provisions and agreements of this Lease.

Assignment and Subletting

Tenant may assign this Lease or sublet or allow the use and occupancy of all or any part of the Premises, without the prior written consent of Landlord, to/with: (i) any parent, subsidiary or affiliate of Tenant; (ii) a joint venturer of Tenant; (iii) any entity resulting from a merger or consolidation with Tenant; (iv) any entity purchasing all or substantially all of the business and assets of Tenant; (v) any entity purchasing all or substantially all of the stock or partnership or membership interests of Tenant; or (vi) the transfer of stock or partnership or membership interests between and among existing shareholders, partners or members and their immediate families

Consequential Damages

In no event shall Tenant be liable for indirect, consequential, special, punitive or exemplary damages (including lost profits or loss of business) incurred or which may be incurred by Landlord.

Space Sharing

So long as Tenant is not in default of any of the terms, covenants, and conditions of this lease, after the expiration of any applicable notice and cure periods, Tenant shall have the right, at any time, and from time to time during the Term, without Landlord's prior written consent, to share portions of the Premises and the facilities, equipment and services therein on a non-demising basis.

A UNIFORM LIST OF TITLE ENDORSEMENTS

SEARLE E. MITNICK is a Member with Gordon Feinblatt LLC, in Baltimore. His practice encompasses real estate and business clients, including commercial real estate developers, residential apartment owners, and borrowers and lenders in loan transactions and workouts. He has formed entities such as partnerships, limited liability companies, and corporations that own and operate real estate and other businesses and has handled major leasing transactions representing national and local landlords and tenants in office buildings and retail centers.

Searle has appeared in court as an expert witness on a number of occasions on cases involving real estate, business, and professional liability matters. He has been a frequent presenter for numerous industry and professional seminars, including the American College of Real Estate Lawyers, the Real Estate Section of the Maryland State Bar Association, the International Council of Shopping Centers (ICSC) Law Conference, and the Maryland Institute for Continuing Professional Education for Lawyers (MICPEL). He is the current Chair of ACREL's Title Insurance Committee. An earlier version of this article appeared in the Fall 2018 ACREL papers. Note: the Forms Committee of the American Land Title Association (ALTA), (chaired by James I. Gosdin, Sr. Vice President and Chief Underwriting Counsel of Stewart Title Guaranty Company and Vice-Chair of the ACREL Title Insurance Committee) has been working to revise many of the ALTA policy provisions and endorsements. When these changes are officially adopted, many of the references and descriptions may no longer be accurate. It is intended that this article will be updated to reflect those revisions.

For many years, our profession and our clients have benefitted from the form legal opinions that have been promulgated and adopted for use in a large variety of commercial and real estate transactions. They have brought relative ease in dealing with what had often been a great source of contention and expense in those transactions.[1]

At the Fall 2015 meeting of the ACREL Title Insurance Committee, Joe Finkelstein, who went on to become chair before me, mused about how nice it would be if we had a similar protocol for title policy endorsements for our transactions. Members of the committee responded with great enthusiasm to his suggestion. Many had stories about selecting endorsements. Some related battles with title companies and lenders; some admitted to being unsure what to ask for themselves. People in firms said that in many instances, each real estate lawyer had his/her own set of endorsements they routinely request. Some members admitted to having been embarrassed when they asked for a certain endorsement, only to learn that the substance of the endorsement had been incorporated into the most recent version of the title policy itself. [2]

The Title Insurance Committee decided this would be a project worth pursuing. As it began its work, the committee first needed to identify all of the available ALTA endorsements and embark on a process to develop consensus on which ones would make the magic list of endorsements that it was seeking to standardize. Which endorsements are sufficiently consequential to make the cut? Which are peripheral in most cases?

Endorsements are amendments or additions to a title insurance policy that typically expand the coverage. They are issued by a title company upon request of an insured party, most often to negate the effect of an exclusion or exception in the policy proper. The 2006 American Land Title Association (ALTA) owner's and loan policies both state: "Each endorsement to this policy issued at any time is made a part of this policy and is subject to all of its terms and provisions. Except as the endorsement expressly states, it does not (i) modify any of the terms and provisions of the policy, (ii) modify any prior endorsement, (iii) extend the Date of Policy, or (iv) increase the Amount of Insurance." While some states have their own endorsement forms, most use the standard ALTA endorsements.[3] Certain ALTA endorsements are not available in particular states, however.[4] Insured parties may also create their own endorsements that are specific to particular transactions.

Often, the cost of the endorsements is a factor in deciding which to request, as some endorsements are available for nominal amounts ($25-$50) while others have a surcharge as much as 20% of the base premium.

The committee set out to inquire which endorsements members generally specify in their purchase and loan transactions. Members of the Title Insurance Committee were polled as to which ALTA endorsements they typically request for owner's and loan title policies.[5]

The variety of responses we received was staggering, as nearly every ALTA endorsement was listed by at least one respondent. One member found that the replies of 12 paralegals he polled at his large, international firm were wholly inconsistent—there are only seven endorsements that all of the paralegals unanimously requested, and together, the paralegals requested nearly 75 unique endorsements.

A few respondents also unknowingly requested ALTA endorsements that are no longer necessary (such as ALTA 1-06, which has been incorporated directly into the 2006 ALTA loan policy as Covered Risk 11(b)) or have been modified (such as the former "Comprehensive Endorsement," which is now contained within ALTA 9 Series coverage).

Some trends did emerge, however, and we were able to assemble a list of 19 ALTA endorsements and/or series of endorsements that are typically requested by the majority of respondents.

Those endorsements are:[6]

- Zoning endorsements (ALTA 3 Series)
- Variable rate mortgage endorsements (ALTA 6 Series)
- Environmental protection lien endorsements (ALTA 8 Series)
- Restrictions, encroachments, minerals endorsements (ALTA 9 Series)
- Aggregation endorsements (ALTA 12 Series)
- Leasehold endorsements (ALTA 13 Series)
- Future advance endorsements (ALTA 14 Series)
- Access endorsements (ALTA 17 Series)
- Tax parcel endorsements (ALTA 18 Series)
- Contiguity endorsements (ALTA 19 Series)
- First loss—multiple parcel transactions endorsement (ALTA 20-06)
- Location endorsements (ALTA 22 Series)
- Doing business endorsement (ALTA 24-06)
- Survey endorsements (ALTA 25 Series)
- Subdivision endorsement (ALTA 26-06)
- Usury endorsement (ALTA 27-06)
- Encroachments and easements endorsements (ALTA 28 Series)
- First loss-identified risk endorsement (ALTA 34-06)
- Minerals and other subsurface substances endorsements (ALTA 35 Series)

Summaries of each of the selected endorsements are intended to afford the practitioner an overview of the subject matter and the variations in the series.[7]

Of course, we recognize that the list we have assembled is, by definition, a generalization and that each case is unique. For example, one rarely needs a mineral rights endorsement (ALTA 35 Series) when purchasing a hotel in downtown Chicago. Thus, much like opinion letters, attorneys must modify this list to suit each transaction.

ALTA 3 SERIES

Zoning Endorsements

ALTA Endorsement 3-06 is designed for vacant properties. It insures against loss or damage due to the insured property (the "Land") not holding a particular zoning classification or certain specified uses not being permitted in that zone. The endorsement also insures against loss or damage if a court order invalidates the zoning ordinance and prohibits those uses. The endorsement does not insure against loss or damage because the Land cannot be sold or mortgaged due to a zoning issue.

ALTA Endorsement 3.1-06 covers improved properties. It insures against loss or damage due to a court order prohibiting the use of the Land for a specified purpose permitted by the zoning ordinance or requiring the removal or alteration of a structure located on the Land because a certain feature of the structure violates the zoning ordinance.

ALTA Endorsement 3.2-06 covers unimproved properties upon which certain improvements may be constructed according to specific plans and specifications.

ALTA 3 Series Endorsements are available for commercial owner's and loan policies.

Before issuing these endorsements, the title company will review the current zoning map and ordinance of the applicable municipality or township.

ALTA 6 SERIES

Variable Rate Mortgage Endorsements

ALTA Endorsement 6-06 insures a lender against loss or damage due to the invalidity or unenforceability of the provisions in the mortgage relating to periodic changes in the interest rate. It also insures a lender against loss of the priority of its lien caused by a change in the interest rate made strictly according to the terms of the mortgage. It does not insure against loss or damage due to usury (see ALTA 27 Series) or any consumer credit protection or truth in lending law, or loss of the priority of a lien caused by a change in the interest rate not contemplated in the mortgage.

ALTA Endorsement 6.2-06 insures a lender against loss or damage due to the failure of the validity and priority of the lien of the mortgage as security for additional principal created by the negative amortization of unpaid interest.

ALTA 6 Series Endorsements are available for commercial and residential loan policies.

Many states prohibit or impair the enforcement of negative amortization mortgages, so the availability of ALTA Endorsement 6.2-06 varies by jurisdiction.

ALTA 8 SERIES

Environmental Protection Lien Endorsements

ALTA 8 Series Endorsements insure against loss or damage due to certain environmental protection liens recorded in the Public Records[8] or in the records of the clerk of the U.S. District Court, other than as listed as exceptions on Schedule B. ALTA Endorsement 8.1-06 insures the priority of the insured mortgage over environmental protection liens. ALTA Endorsement 8.2-06 insures against loss caused by a recorded environmental protection lien.

ALTA Endorsement 8.1-06 is available only for residential loan policies. ALTA Endorsement 8.2-06 is available for commercial owner's and loan policies.

ALTA 9 SERIES

Restrictions, Encroachments, Minerals Endorsements

The ALTA 9 Series Endorsements, often called the "Comprehensive Endorsements," are meant to consolidate many of the endorsements often requested by lenders or real estate purchasers into a single endorsement. Before issuing these endorsements, the title company may require a survey and/or evidence that any covenants affecting the Land have not been violated. To avoid confusion, this summary groups the ALTA 9 Series Endorsements by loan and owner's policies.

Loan Policies

ALTA Endorsement 9-06 insures a lender against loss or damage due to: violations of any covenant, condition, limitation or restriction, other than as listed as exceptions on Schedule B; existing encroachments across property lines or onto easements; damage to existing improvements that may result from the exercise of easement rights or mineral interests; and a final court order requiring the removal of an encroachment or denying the right to maintain an existing improvement. This endorsement is only available for improved properties.

ALTA Endorsement 9.3-06 differs from ALTA Endorsement 9-06 in that it does not insure over encroachments or damage resulting from the future exercise of any right to use the surface of the Land for the extraction or development of minerals.

ALTA Endorsement 9.6-06 adds coverage beyond what is provided in ALTA Endorsement 9-06 against loss or damage due to the enforcement of a Private Right (defined as (i) a private charge or assessment, (ii) an option to purchase, (iii) a right of first refusal, or (iv) a right of prior approval of a future purchaser or occupant) in a covenant affecting title on or before the policy date.

ALTA Endorsement 9.7-06 includes much of what is contained within ALTA Endorsement 9-06, except that it more clearly contemplates future improvements on the property.

ALTA Endorsement 9.10-06 differs from ALTA Endorsement 9-06 in that it only covers a violation of a covenant at the policy date, and not future violations.

Owner's Policies

ALTA Endorsement 9.1-06 insures against loss or damage due to violations of any covenant, condition, limitation or restriction, other than as listed as exceptions on Schedule B. This endorsement is available only for unimproved properties.

ALTA Endorsement 9.2-06 differs from ALTA Endorsement 9.1-06 in that it also insures against loss or damage due to the enforced removal of an improvement and in that it is available only for improved properties.

ALTA Endorsement 9.8-06 differs from ALTA Endorsement 9.2-06 in that it is available for properties under development.

ALTA Endorsement 9.9-06 adds coverage beyond what is proved in ALTA Endorsement 9.1-06 against loss or damage due to the enforcement of a Private Right (defined as (i) an option to purchase, (ii) a right of first refusal, or (iii) a right of prior approval of a future purchaser or occupant) in a covenant affecting title on or before the policy date.

ALTA 12 SERIES

Aggregation Endorsements

The need for ALTA Endorsement 12-06 arises in situations in which mortgages affecting properties in different jurisdictions are recorded for the full amount of the secured loan. Instead of combining the properties into one loan policy, ALTA Endorsement 12-06 allows the title insurer to issue multiple policies for lesser amounts and then tie the policies together so that the lender can take advantage of any increases in the value of a particular property if there is a loss. ALTA Endorsement 12-06 accomplishes this by amending Sections 7, 8, and 10 of the policy so that the amount of insurance available to cover a loss is the aggregate of the amount of insurance under this policy plus the amounts of insurance under other identified policies.

ALTA Endorsement 12.1-06 is used in states having caps on insurance policy amounts.

ALTA 12 Series Endorsements are available for commercial loan policies.

The following conditions may apply to ALTA 12 Series Endorsements: (i) they may be approved only when the same form of loan policy is being used; (ii) the loan amount must be secured by mortgages on two or more properties; (iii) each insured mortgage must state that it secures the entire indebtedness; (iv) the amount of insurance of each policy will be equal to the amount that the insured allocates to the property described therein; and (v) policies of different title insurers cannot be tied together.

ALTA 13 SERIES

Leasehold Endorsements

ALTA Endorsements 13-06 and 13.1-06 are used either with policies covering only leasehold estates or both leasehold estates and the ownership of improvements located on them.

These endorsements modify the ALTA owner's and loan policies by (i) adding the definition of a leasehold, (ii) modifying the calculation of damages, (iii) redefining valuation of the estate to include the value of the remaining lease term and any tenant leasehold improvements, and (iv) adding additional items taken into consideration for the determination of loss, such as relocation expenses, costs of obtaining a new lease, and the cost of tenant leasehold improvements. These endorsements do not insure against loss or damage due to remediation resulting from environmental contamination nor do they insure current compliance with the terms of the lease.

ALTA Endorsement 13-06 is available for commercial and residential owner's policies. ALTA Endorsement 13.1-06 is available for commercial and residential loan policies.

ALTA 14 SERIES

Future Advance Endorsements

ALTA Endorsement 14-06 insures a lender against loss or damage due to the loss of priority of future advances under the loan secured by the insured mortgage. The endorsement also provides variable rate coverage.

ALTA Endorsement 14.1-06 differs from ALTA Endorsement 14-06 in that it does not insure against loss or damage due to future advances made after the lender has knowledge of liens or encumbrances affecting the insured property.

ALTA Endorsement 14.2-06 insures a lender against loss or damage due to the loss of priority of future advances made pursuant to a letter of credit, surety agreement or reimbursement agreement secured by the insured mortgage.

ALTA Endorsement 14.3-06 differs from ALTA Endorsement 14-06 in that it further insures against loss or damage due to the mortgagor not being at least 62 years old, a requirement for a mortgagor to qualify for a reverse mortgage loan.

ALTA Endorsement 14-06 is available for commercial and residential loan policies. ALTA Endorsement 14.1-06 is available for commercial and residential loan policies. ALTA Endorsement 14.2-06 is available for commercial loan policies. ALTA Endorsement 14.3-06 is available for residential loan policies.

ALTA 17 SERIES

Access Endorsements

ALTA Endorsements 17-06 and 17.1-06 insure against loss or damage if (i) the Land does not have both vehicular and pedestrian access to and from a named street, (ii) the named street is not physically open and publicly maintained, or (iii) the policy holder has no right to use existing curb cuts or entries along the portion of the street abutting the Land. ALTA 17-06 insures that there is direct access to the street, while ALTA 17.1-06 insures that access to the street is provided by an identified easement.

ALTA Endorsement 17.2-06 insures against loss or damage if the policy holder lacks a right of access to the utilities specified in the endorsement.

Whereas ALTA owner's and loan policies insure against loss or damage by reason of a lack of "a right of access to and from the Land," they do not address the extent, location, or means of that access; ALTA Endorsements 17-06 and 17.1-06 go further by specifically addressing the location, use, and quality of access.

ALTA Endorsement 17-06 is available for commercial and residential owner's and loan policies. ALTA Endorsement 17.1-06 is available for commercial and residential owner's and loan policies. ALTA

Endorsement 17.2-06 is available for commercial owner's and loan policies.

Before issuing these endorsements, the title company may require a survey. A title company may not issue these endorsements if the public records disclose a limitation in rights of access (for example, limitation of access along a highway).

ALTA 18 SERIES

Tax Parcel Endorsements

ALTA Endorsement 18-06 insures against loss or damage in the event that the Land does not constitute a separate parcel for real estate tax purposes, or in the event that the tax identification number stated in the endorsement affects other property in addition to the Land. ALTA Endorsement 18.1-06 provides similar coverage, except this endorsement is used when multiple parcels with multiple tax identification numbers are the subject of the title policy. ALTA Endorsement 18.1-06 also insures against loss or damage if the easements, if any, described in Schedule A of the policy are terminated or disturbed by the non-payment of taxes.

ALTA 18 Series Endorsements are available for commercial owner's and loan policies.

Before issuing these endorsements, a title company usually will compare the description of the Land on Schedule A with the legal description on the tax rolls; if the description of the Land includes only a portion of the tax description, the title company will not issue the endorsement.

ALTA 19 SERIES

Contiguity Endorsements

ALTA Endorsement 19-06 insures against loss or damage in the event that multiple parcels described in Schedule A of the title policy are not contiguous to each other.

ALTA Endorsement 19.1-06 insures against loss or damage in the event that the single parcel described in Schedule A is not contiguous to another adjoining property not insured under the title policy, which adjoining property usually was acquired by the insured in a separate transaction.

ALTA Endorsement 19.2-06 insures against loss or damage in the event that specific groups of parcels within the description of the Land are not contiguous.

ALTA 19 Series Endorsements are available for commercial owner's and loan policies.

Before issuing these endorsements, the title company may require a survey.

ALTA 20-06

First Loss – Multiple Parcel Transactions Endorsement

ALTA Endorsement 20-06 alters the definition and measurement of actual loss under a loan policy. Usually "loss" is defined as the difference between the value of the property with and without the defect, lien or encumbrance against which the title policy is insuring, which is difficult to determine without the insured lender foreclosing on all parcels being secured by the mortgage and the property being sold for less than the outstanding debt. This endorsement allows the recognition of a loss whenever a title defect materially impairs the value of one parcel securing the loan, without requiring acceleration of the debt and foreclosure against all of the parcels securing the loan. In other words, this endorsement allows assertion of loss on the basis of impairment of the mortgage as if each parcel were security for a separate loan. Under this endorsement, loss is considered an interim situation that is contingent upon the remaining property failing to provide adequate security for the unpaid debt.

ALTA Endorsement 20-06 is available for commercial loan policies involving more than one parcel of property.

ALTA 22 SERIES

Location Endorsements

ALTA Endorsements 22-06 and 22.1-06 insure against loss or damage if improvements described by street address are not located on the Land. Additionally, ALTA 22.1-06 insures against loss or damage due to a copy of a recorded plat or map attached to the endorsement not accurately reflecting the location and dimensions of the Land as shown in the public records.

ALTA Endorsement 22-06 is available for commercial and residential owner's and loan policies. ALTA Endorsement 22.1-06 is available for commercial and residential loan policies.

ALTA 24-06

Doing Business Endorsement

ALTA Endorsement 24-06 insures against loss or damage in the event that the lien of the mortgage is invalid or unenforceable because of the failure of the insured to qualify to do business within the state in which the property is located. It modifies Exclusion 4 of the ALTA loan policy regarding doing business regulations and laws.

ALTA Endorsement 24-06 is available for commercial loan policies.

ALTA 25 SERIES

Survey Endorsements

A lender usually requests the ALTA 25 Series Endorsements (fondly referred to in the industry as "same as survey" endorsements) if there is a new survey, or if the title policy or the insured mortgage contains a legal description that varies from the description of the Land in the survey identified in the endorsement. A purchaser may want to obtain these endorsements if the seller delivers a deed with the same legal description as described in the deed by which the seller received title, but which is different from the current survey description.

ALTA Endorsements 25-06 and 25.1-06 insure against loss or damage in the event that the Land is not the same as the land on the survey identified in the endorsement. ALTA Endorsement 25-06 is used when the Land is identical to all of the land shown on the survey. ALTA Endorsement 25.1-06 is used when the Land is identical to a portion of the land shown on the survey.

ALTA 25 Series Endorsements are available for commercial owner's and loan policies. Before issuing these endorsements, a title company will almost certainly require a survey.

ALTA 26-06

Subdivision Endorsement

ALTA Endorsement 26-06 insures against loss or damage resulting from the failure of the Land to constitute a legally created parcel pursuant to applicable state and local laws. It modifies Exclusion 1 of the ALTA owner's and loan policies, which excludes violation of subdivision laws from coverage.

ALTA Endorsement 26-06 is available for commercial owner's and loan policies. Before issuing this endorsement, a title company may require a survey to compare with state and local subdivision requirements.

ALTA 27-06

Usury Endorsement

ALTA Endorsement 27-06 insures against loss or damage in the event that the lien of the mortgage is invalid or unenforceable due to violation of state usury laws. It amends Exclusion 5 of the ALTA loan policy.

ALTA Endorsement 27-06 is available for commercial loan policies. This endorsement is not available in many states and in others is available only with modifications.

ALTA 28 SERIES

Encroachments And Easements Endorsements

ALTA Endorsement 28-06 insures against loss resulting from damage to or removal of an existing improvement on the Land due to its obstruction of the use of an easement identified in the title policy.

ALTA Endorsements 28.1-06, 28.2-06, and 28.3-06 insure against loss or damage resulting from (i) an encroachment of any improvement located on the Land onto an adjoining property or onto an easement located on the Land but not identified in the title policy, (ii) an encroachment of any improvement located on an adjoining property onto the Land, (iii) the enforced removal of any improvement on the Land based on its encroachment onto any portion of the Land subject to an easement, and (iv) the enforced removal of any improvement on the Land based on its encroachment onto an adjoining property. ALTA Endorsement 28.1-06 covers properties improved with buildings; ALTA Endorsement 28.2-06 covers properties improved by structures beyond buildings; and ALTA Endorsement 28.3-06 covers properties that contemplate future improvements.

ALTA 28 Series Endorsements provide broader coverage than Covered Risk 2(c) of the ALTA owner's and loan policies, which states as follows:

> Any encroachment, encumbrance, violation, variation, or adverse circumstance affecting the Title that would be disclosed by an accurate and complete land survey of the Land. The term "encroachment" includes encroachments of existing improvements located on the Land onto adjoining land, and encroachments onto the Land of existing improvements located on adjoining land.

ALTA 28 Series Endorsements are available for commercial owner's and loan policies.

Before issuing these endorsements, a title company may require a survey or inspection of the property.

ALTA 34-06

First Loss – Identified Risk Endorsement

ALTA Endorsement 34-06 can be used when a particular title risk has been identified in an exception over which the title company is willing to insure, but without obligating itself to remove or obtain removal of the identified risk. Typically, the title company will have concluded that the risk is more theoretical than likely to cause a loss. It should be noted that in essence, the title company is establishing insurable rather than marketable title. In many cases, this may be sufficient to permit the transaction to close.

ALTA Endorsement 34-06 is available for commercial and residential owner's and loan policies for improved or unimproved property.

ALTA 35 SERIES

Minerals And Other Subsurface Substances Endorsements

ALTA Endorsements 35-06, 35.1-06, 35.2-06, and 35.3-06 insure against loss or damage to existing improvements resulting from the use of the surface of the Land to extract or develop minerals or other subsurface substances. These endorsements allow the title company to identify specific grants or reservations of mineral rights which it is not willing to insure.

ALTA 35 Series Endorsements differ only in their definitions of "Improvement." They are available for commercial and residential owner's and loan policies.

ACKNOWLEDGEMENTS

Sources consulted for the summaries contained herein include:

- Fidelity National Title Group, Inc., Endorsement Manual (April 2015).
- First American Title Insurance Company, Endorsement Guide: A brief overview of ALTA Title Insurance Endorsements (March 2014).
- James L. Gosdin, Title Insurance: A Comprehensive Overview of the Law and Coverage (Fourth Edition, American Bar Association 2015).

Notes

1 ACREL members have been instrumental in the successful efforts to reach consensus on these opinions. For more information, see the materials assembled by the ACREL Attorneys' Opinion Committee at ACREL Shares. See also materials at the ABA Section of Real Property Trust & Estate Law website: http://apps.americanbar.org/dch/committee.cfm?com=RP213000

2 It should be noted that there are conceptual differences between acceptable opinion forms and a list of commonly used title policy endorsements. The form opinion constitutes a peace treaty of sorts among the various parties to the transaction. Typically the lender requires a legal opinion from borrower's counsel. Before the adoption of standard opinions forms, much time and expense were devoted to hashing out the details of these opinions. Typically, lenders wanted more, and borrower's counsel wanted to give less. To be sure, the parties still debate such things as the assumptions on which borrower's counsel may rely and the scope and inclusiveness of the opinion, but the battles are typically much more limited and constrained than before the prevalence and acceptance of such opinions.

3 Some states with their own endorsement forms include Texas, Pennsylvania, and California. The California endorsement forms are provided by the California Land Title Association (CLTA) and are more voluminous than the ALTA forms.

4 For instance, ALTA Endorsement 06-27 regarding usury is not available in Alaska, Delaware, Florida, Idaho, Kansas, Missouri, New Jersey, New Mexico, New York, Oregon, Pennsylvania, Texas, and Vermont, and is not available without modification in Colorado, Georgia, Massachusetts, Michigan, and North Carolina.

5 Certain ALTA endorsements are specific to commercial properties and others are specific to residential properties. Our study focused only on the commercial endorsements.

6 We note that some of these endorsements are listed individually while others are listed as a series. The endorsements in each series are slightly different from one another. These differences are explained in the summaries that follow.

7 The endorsements themselves and more comprehensive summaries may be found as follows:

1. Fidelity National Title Group, Inc., Endorsement Manual (April 2015).
2. First American Title Insurance Company, Endorsement Guide: A brief overview of ALTA Title Insurance Endorsements (March 2014).
3. James L. Gosdin, Title Insurance: A Comprehensive Overview of the Law and Coverage (Fourth Edition, American Bar Association 2015).

8 The ALTA owner's and loan policies define "Public Records" as "Records established under state statutes at Date of Policy for the purpose of imparting constructive notice of matters relating to real property to purchasers for value and without Knowledge."