

Second Thoughts On Defaulted Leases

by Joshua Stein



Somewhere in every 50-plus-page commercial lease, the document defines how much money the tenant must, at least in theory, pay the landlord in damages if the tenant defaults. Typically, under those circumstances, standard lease language gives the landlord two options if the landlord enforces the words of the lease.

As one option, the landlord can leave the lease in place, let the tenant stay and sue every month for the rent. This has a certain lack of appeal to it, because a tenant that has stopped paying rent probably won't start paying rent again just because the landlord sued. If the landlord recovers a judgment for unpaid rent, the judgment may and may not – and probably won't – be worth anything. And the landlord will have forgone the possibility of collecting rent from some other tenant.

So the landlord will often prefer the second option: terminating the lease and getting back possession of the space. In that case, a typical lease doesn't allow the landlord to collect all the unpaid rent for what would have been the remaining term of the lease (the "aborted term"). Instead, the landlord can only sue the tenant for a limited formulaic amount.

First, the court measures the rental value of the space for the aborted term. Second, the court measures the contract rent the tenant was supposed to pay in the aborted term. If the contract rent exceeds the rental value, then the landlord can theoretically recover that excess from the defaulting tenant, discounted back to present value. It's sometimes called the "bonus rent."

On the other hand, if the rental value exceeds the contract value, then the landlord can't recover anything at all. In this case, the landlord is expected to rerent the space to someone else during the aborted term, collect the rental value and theoretically end up better off than if the defaulting tenant had stayed in the space. At least that's the theory.

From a landlord's perspective, reality doesn't match the theory – a common problem in lots of areas. When the landlord signed the lease with the defaulting tenant, the landlord incurred leasing commissions, tenant improvement costs and vacancy period losses. Those amounted to a capital investment that was supposed to give the landlord contract rent for the term of the lease. If the lease terminates early, the landlord might not recover anything at all from the defaulting tenant – if there turns out to be no bonus rent – but the landlord also doesn't get the full benefit of the capital investment it made. And the landlord may need to incur the same capital investment a second time to find a new tenant.

For that reason, a minority of leases say that if the landlord terminates the lease because of a tenant default, the tenant must, whether or not there is any bonus rent, also reimburse the

unamortized capital investment the landlord incurred to enter into the lease. Tenants often object to that concept, arguing that the ordinary formulas for the landlord's recovery in any lease will make the landlord whole. As demonstrated above, though, they very well might not. The bonus rent formula assumes the landlord will be able to re-rent the space quickly, easily and at no cost, and then recover the rental value during the entire aborted term. Reality doesn't necessarily work that way. So why shouldn't the landlord also try to recover for the part of its capital investment in the lease that ultimately went to waste?

All of this matters, of course, only if the defaulting tenant might ultimately pay up. Sometimes, with a creditworthy tenant, the landlord could actually recover something from the tenant. Of course those are the cases where the tenant will stick around and pay the rent and not default.

In the other cases, usually the landlord will never recover anything, so playing with how to define the landlord's recovery is really just playing with oneself. In those cases, the landlord's real agenda consists not so much of recovering a hypothetical amount from a deadbeat, but instead getting the defaulting tenant out of the space. The courts often don't make it very easy to do that, but that's another discussion.

As a matter of lease drafting, though, landlords may want to rethink their reliance on the two "standard" options described above, because neither is really very good. Instead, landlords might want to at least try to make the defaulting tenant responsible for the wasted part of the landlord's capital investment in the lease. Sometimes the landlord just might be able to recover accordingly. But if the lease didn't provide for it, then the landlord has no chance of recovery at all. You can't win it if you aren't in it.

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