

## **Leasing After COVID, Part III: Early Termination Provisions**

*The challenges and uncertainties faced by many commercial tenants during the COVID-19 pandemic have led parties to spend more time and attention on lease provisions relating to termination. In Part 3 of their series "Leasing After COVID," Ann Ryan and Adrienne Koch examine two types of termination provisions that have received particular attention in recent months: co-tenancy and gross sales "kick-out" provisions.*

**By Ann E. Ryan and Adrienne B. Koch (December 14, 2021)**

"Contracts are like hearts, they're made to be broken," says a smirking Michael Keaton, playing Ray Kroc in the movie *The Founder*. As many tenants discovered during the COVID-19 pandemic, this philosophy is not true of commercial leases. Unless the lease specifically gives the tenant a right to terminate, the tenant cannot simply walk away from its lease without risking substantial liability.

During the COVID-19 pandemic, some tenants were able to negotiate termination agreements with their landlords. But even though a landlord may agree to terminate a lease to regain control of a defaulting tenant's space without costly and lengthy litigation, typically a defaulting tenant that otherwise has no contractual right to terminate its lease will be in a much weaker bargaining position with respect to the conditions for termination (which often include a hefty fee).

The challenges and uncertainties faced by many commercial tenants during the COVID-19 pandemic have led parties to spend more time and attention on lease provisions relating to termination. This article (the third in a three-part series) examines two types of termination provisions that have received particular attention in recent months: co-tenancy and gross sales "kick-out" provisions.

Co-tenancy provisions, which are often found in shopping center leases, usually give the tenant a right to a rent abatement or a rent reduction—and often an eventual right to terminate its lease—under one of two circumstances: (i) one or more specified tenants (usually anchor tenants) are not open and operating in their premises during a particular period or for a particular length of time; or (ii) a certain percentage of the shopping center is not occupied by retail (or other specified types of) tenants that are open for business in their premises. Gross sales "kick out" provisions are more focused on the tenant itself: they allow one or both parties to terminate a retail lease if the tenant fails to achieve a specified threshold of gross sales during a certain period.

During the government-mandated shut-downs of non-essential businesses as a result of COVID-19, many tenants looked to these kinds of provisions for relief, but did not always find the "out" they were seeking. Co-tenancy and gross sales kick-out provisions typically specify that they can only be invoked by a tenant that is itself open, operating, and not otherwise in default—requirements that most retail establishments could not meet because they were forced to suspend their own operations. In addition, many such provisions include carve-outs for casualty or force majeure.

Nevertheless, the attention paid to termination provisions in light of the pandemic has highlighted some of the issues that landlords and tenants must address with care when drafting leases. Two recent cases involving shopping center tenants illustrate these issues.

### **Example 1: Starbucks**

The first is an action in the Southern District of New York entitled *New WTC Retail Owner LLC v. Starbucks Corporation*, Case No. 1:21-cv-07132-VEC. According to the complaint, the parties' lease gave Starbucks, a tenant in the shopping center owned by WTC, the option to terminate the lease if its gross sales in the premises during a particular measuring period were less than \$2,500,000. To exercise the option, Starbucks was required to give WTC notice within 30 days after the expiration of the measuring period and pay a termination fee calculated pursuant to a formula. The termination option could not be exercised, however, if Starbucks was not open and operating during the entire measuring period or was in default under the lease beyond applicable notice and cure periods.

The measuring period ran from April 1, 2020 through March 31, 2021. For roughly the first half of that period, the shopping center was shut down due to COVID-19. According to the complaint, Starbucks failed to reopen after that shut-down concluded on Sept. 9, 2020, and had still not re-opened as of August 2021.

Starbucks attempted to exercise its termination option; WTC brought suit challenging that exercise. In addition to claiming that Starbucks failed to comply with certain procedural requirements concerning the timing of the notice, delivery of the termination fee, and the provision of financial back-up information, WTC claims that Starbucks had no right to terminate because it remained closed from Sept. 9, 2020 through March 31, 2021—more than six months of the measuring period that followed the conclusion of the government-mandated shut-down. Starbucks has asserted counterclaims, alleging that WTC prevented it from reopening by closing off its portion of the shopping center “until approximately February 2021.”

Although this case is in its infancy, it highlights several important considerations with respect to termination options:

- Termination options almost always require that the tenant is not in default when the option is exercised, and/or as of the date the lease is terminated. Tenants should try to negotiate this provision so that (as in the Starbucks lease) the termination option will not be extinguished unless the tenant is in default beyond any applicable notice and cure period.
- Landlords and tenants should also understand and carefully negotiate any other conditions regarding the effectiveness of the termination option (such as the requirement in the Starbucks lease that the tenant had to be open and operating during the entire measuring period) and pay careful attention to any provision that delineates circumstances under which any such condition will be excused.
- The mechanics of how and when the termination option is exercised need to be drafted as clearly as possible. If the date by which the tenant must send the termination notice is defined in relation to certain events (such as an anniversary of the commencement date or rent commencement date), the tenant should make sure that the actual date of any such event is confirmed in writing. If a termination fee is required, the termination provision should clearly state the amount of the fee (or how it should be calculated) and the date it is due. If the fee is based on certain landlord costs, the manner in which these costs will be communicated to the tenant should be stipulated.

## **Example 2: J. Crew**

Another recent case, *Eastview Mall v. Grace Holmes*, 182 A.D.3d 1057 (4th Dept. 2020), involves events that largely pre-date the pandemic but is nevertheless also illustrative. The parties' lease gave the tenant (J. Crew) an option to terminate if its gross sales fell below a certain amount during the fifth year of the lease. When J. Crew exercised that option, its landlord (Eastview) disputed the calculation of gross sales.

Eastview sought a preliminary injunction to prevent J. Crew from terminating the lease, claiming that it would trigger the rights of other shopping center tenants to terminate their own leases based on co-tenancy provisions.

Over a two-justice dissent, the court reversed the lower court's order granting the preliminary injunction. It found that Eastview had not demonstrated that the termination would cause it irreparable harm. The lease's liquidated damages provision, the court reasoned, represented the parties' agreement that any harm from a wrongful termination by J. Crew was compensable in money damages.

This case highlights a different set of considerations that parties should keep in mind in drafting termination options:

- If the provision gives the tenant an option to terminate based on its gross sales, the landlord should ensure not only that it has a right to inspect and audit the tenant's financial records, but also that the method of calculating gross sales is clear.
- If the tenant is an anchor tenant, the landlord must think carefully about what impact a termination will have with respect to other tenants' co-tenancy rights. A landlord's counsel should ensure that any co-tenancy provisions include: (i) adequate cure periods; (ii) provisions dealing with force majeure, casualty and condemnation; and (iii) an ability to substitute a specific required co-tenant with another tenant or combination of tenants.

## **Lessons Going Forward**

One of the many lessons of the COVID-19 pandemic is that life is unpredictable. To move forward in the commercial leasing market, parties must be creative to address previously unanticipated challenges and rethink lease provisions that, in the past, may not have received a great deal of attention.

This series has examined three kinds of provisions that require such creativity and care: casualty provisions, tenant security, and termination provisions. There are doubtless numerous others. One common trait of these three provisions is that they all address situations where something has not gone as the parties hoped.

When parties first enter into a lease, they tend not to want to think about potential disruptions caused by casualties, defaults, or a future need to terminate. But the beginning of a lease relationship, when the parties are cooperatively planning a future together, is often the best time to think about and carefully plan for these possibilities.

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