Bankruptcy, Guarantees, Insurance, Leases, Lenders, Sublease

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Bankruptcy

The Ninth Circuit held that the statutory cap on landlord's damages for a lease terminated before or during a tenant's bankruptcy only applies to claims resulting directly from the lease termination and does not apply if landlord's damages would have existed whether or not the lease was terminated. *Kupfer v. Salma (In re Kupfer)*, Case No. 14-16697 (9th Cir. Dec. 29, 2016).

Konstantin and Margarita Kupfer ("Tenants") leased two commercial properties in California from the trustees of the Salma Family Trust ("Landlords"), for terms of 10 years each. Each lease included an arbitration clause and a provision that attorney fees, arbitration fees and costs would be awarded to the prevailing party. Tenants stopped paying rent and eventually vacated the premises, so Landlords brought an action for breach of both leases. The claims went to arbitration, where Landlords were awarded damages of almost $1.3 million for unpaid past rent and future rent discounted to present value, as well as attorney fees and arbitration fees totaling almost $200,000.

Tenants then filed for Chapter 11 bankruptcy. Landlords filed a proof of claim for the arbitration award, to which Tenants objected, arguing that the entire award, including attorney and arbitration fees, should be limited by the cap in 11 U.S.C. § 502(b)(6). Landlords argued the cap should apply to past and future rent, but not to the fee award. The bankruptcy court found in favor of the Landlords, and the district court affirmed, allowing Landlords to recover a capped amount for past and future rent and the entire amount for attorney and arbitration fees.

In previous cases, the Ninth Circuit found that the statutory cap in 11 U.S.C. § 502(b)(6) only applies to damages *directly* resulting from lease termination. Using a test established in *In re El Toro Materials Co.*, 504 F.3d 978 (9th Cir. 2007) and adopted by the Eighth Circuit, the Ninth Circuit considered whether Landlords would have the same claim against Tenants if the lease had not been terminated.

Consequently, the Ninth Circuit partially reversed the bankruptcy and district court rulings, holding that the statutory cap only extends to the portion of the fee award related to Landlord's claims for future rent, as those fees would not have arisen but for the lease termination. The award for fees related to claims for unpaid past rent did not arise from the lease termination and thus were not subject to the statutory cap. Additionally, fees and costs associated with a debtor's counterclaims are not subject to the cap to the extent they concern ordinary breaches, independent of lease termination. The Ninth Circuit therefore remanded the case for further proceedings in order to apportion the attorney and arbitration fee award appropriately.

Guarantees

The Supreme Court of Rhode Island has ruled on the enforceability and scope of a lease guaranty. The court upheld a personal guarantee by the principal of the tenant, including additional rent and attorney's fees. *OSJ of Providence, LLC v. Ali T. Diene*, No. 2016-14-Appeal PC 14-436 (R.I., February 24, 2017).

Bayal Restaurant, Inc., as tenant, entered into a lease in February 2012. OSJ of Providence, LLC, acquired the property in January 2013, thus succeeding to the interest of the original landlord. The lease was for a term of five years. The principal of the tenant, Aly T. Diene, executed a personal guaranty, which included a provision stating that the guaranty would expire on the last day of the twelfth full month following the lease Rent Commencement Date. Based on the actual events, the guaranty expiration date was September 30, 2013.

The tenant defaulted in the payment of rent for February, March and April 2013. After receiving a demand letter from the landlord, the tenant made a partial payment. No further payments were made, and more demand letters were sent. Those demand letters included reminders that the guarantor was "responsible for all amounts due and owing to Landlord under the Lease." In June 2013 the landlord filed a complaint for eviction, and the parties subsequently entered into a stipulated judgment against the tenant for approximately $17,000; the judgment also stipulated that all other terms and conditions of the lease would remain in full force and effect.

The tenant then failed to make any payments pursuant to the stipulated judgment, so in January 2014 the landlord filed a complaint against the guarantor for default under the guaranty. The plaintiff landlord was successful in seeking summary judgment in that matter, and a judgment was entered against the defendant guarantor for almost $38,000. The defendant guarantor appealed, contending that the action filed in January 2014 was untimely because it was filed three months after the guaranty had expired, the hearing justice should have permitted a defense that plaintiff landlord breached the lease first, and the hearing justice was incorrect in awarding attorneys' fees and "extra" rent as part of damages.

Neither party questioned the validity of the lease or the guaranty, nor did they argue that there was any ambiguity in either document. The guarantor argued that the stated expiration date in the guaranty was, in effect, a shortened, privately agreed limitations period after which no suit on the guaranty could be brought. The court disagreed, concluding that the guaranty expiration date was, in fact, the date through which the performance of tenant's obligations had been guaranteed and that it did not mean that September 30, 2013, was the last day upon which the landlord could bring an action against the guarantor.

As noted above, the guarantor also argued that the hearing justice should have allowed an argument that the landlord breached the lease first. The court rejected that argument, noting that the tenant's liability to the landlord was decided in the first eviction action, the guarantor guaranteed that liability, and the guarantor could not have another bite of the apple. Finally, the court rejected the guarantor's argument that attorneys' fees and "extra" rent should not have been awarded, reciting the plain language of the lease and the guaranty that provided for the payment of attorneys' fees and additional rent.

Insurance

The Florida Supreme Court concluded that the exclusion of coverage for one concurrent cause did not negate coverage entirely where other concurrent causes were covered under the language of the insurance policy. *Sebo v. American Home Assurance Company, Inc.*, No. SC14-897 (Fla., December 1, 2016).

The plaintiff purchased improved real property (in this case, a four-year-old home) in Naples, Florida, in 2005, and obtained an "all-risk" policy of insurance from the defendant insurer, insuring the improvements for more than $8,000,000. The property improvements suffered from "major design and construction defects," and "water began to intrude during rainstorms." The damage continued for several months during 2005. In October 2005, Hurricane Wilma caused further damage.

All of the damage was reported to the insurer in December 2005. The insurer investigated, and in April 2006, it denied coverage for most of the claims, other than $50,000 for mold coverage. The improvements could not be repaired and were eventually demolished. The property owner subsequently filed suit against the property sellers, the architect and the construction company, later adding the defendant insurer and seeking a declaratory judgment that the policy provided coverage. The plaintiff was awarded a jury verdict and judgment was entered against the insurer. On appeal to the intermediate appellate court, the judgment was reversed, and the plaintiff property owner then appealed to the Florida Supreme Court.

As stated by the court:

> The issue presented is whether coverage exists under Sebo's all-risk policy when multiple perils combined to create a loss and at least one of the perils is excluded by the terms of the policy.

The court noted that an "all-risk" policy is not an "all loss" policy and does not extend coverage for every possible claim. Rather, insurance contracts are to be "construed in accordance with the plain language of the policy," but "if the language is susceptible to more than one reasonable interpretation and is therefore ambiguous, the policy will be strictly construed against the insurer and in favor of the insured."

In examining the facts of the case, the court considered two competing theories of coverage, the Efficient Proximate Cause doctrine and the Concurrent Cause doctrine. The Efficient Proximate Cause doctrine makes a "distinction between a covered peril setting into motion an uncovered peril and an uncovered peril setting into motion a covered peril. Coverage exists for the former but not the latter." On the other hand, the Concurrent Cause doctrine "provides that coverage may exist where an insured risk constitutes a concurrent cause of the loss even when it is not the prime or efficient cause."

In this case, the insurance policy contained express exclusions for losses resulting from faulty design, planning, materials, construction and workmanship. However, it was not disputed that "rainwater and hurricane winds

combined with the defective construction to cause the damage." The court noted that there was no reasonable way to distinguish the proximate cause of the damage, since the construction defects and the rain and wind combined to create the destruction of the improvements, so the Efficient Proximate Cause doctrine could not be applied. Instead, the court adopted and applied the Concurrent Cause doctrine, citing and agreeing with an earlier intermediate appellate case (*Wallach v. Rosenberg*, 527 So. 2d 1386 (Fla. 3d DCA 1988)):

> As stated in Wallach, "[w]here weather perils combine with human negligence to cause a loss, it seems logical and reasonable to find the loss covered by an all-risk policy even if one of the causes is excluded from coverage."

The court quashed the appellate court's reversal of the trial court verdict and judgment for the plaintiff property owner.

Leases

The Minnesota district court held that a tenant's obligation to surrender premises in good condition, wear and tear excepted, does not require the tenant to undertake code-compliance work required after lease terminates. *H.F.S Properties v. Foot Locker Specialty, Inc.*, Case No. 15-3273 (D. Minn. February 2, 2017).

Foot Locker's predecessor executed two leases, one in 1920, and one in 1949, for adjacent parcels of land in St. Paul, Minnesota. In 1955, Foot Locker constructed the Woolworth Building in St. Paul, Minnesota, on the parcels. The 1920 lease required Foot Locker to keep the building in good order and repair during the term of the lease, but did not contain an exception for wear and tear and did not describe Foot Locker's obligations upon surrender. The 1949 lease contained a surrender clause stating that Foot Locker would surrender the premises in good condition, wear and tear excepted. Both leases expired on June 30, 2015, but Foot Locker ceased occupying the building in 1993, and the building was unoccupied. Foot Locker subleased the building to a third-party user in 1998, but it then became unoccupied again in 2001. H.F.S Properties (HFS) purchased the leased land in 1999.

Under the leases, Foot Locker was not obligated to occupy the buildings. Foot Locker continued to pay rent, registered the buildings as vacant as required by the municipality and resolved all maintenance issues identified by HFS and the municipality. Because the building was registered as vacant, the city revoked the certificates of occupancy. During subsequent inspections, a number of code violations were noted and would have been required to be repaired prior to occupancy of the building.

Generally, HFS argued that Foot Locker failed to keep the building in good repair, and that Foot Locker was required to surrender the building in a condition sufficient for a new certificate of occupancy to be issued. HFS claimed that Foot Locker was required to pay $11 million to repair the building, including, in addition to a number of other items, installing new elevators, stairwells, windows, plumbing and sprinklers.

The court rejected HFS's argument, finding that Foot Locker was only responsible for the cost of performing repairs required by the lease, and Foot Locker's only obligation was to surrender the building in good condition, wear and tear excepted. The court stated that, because of the length of the lease terms, requiring surrender of the building with no wear and tear exception would amount to requiring a complete renovation at the end of the lease term. Additionally, the court noted that at the end of the lease term, the building had been vacant for almost 15 years and had more than 100 code violations, and therefore the standard put forth by HFS would require Foot Locker to undertake work to comply with the current zoning, building and fire codes. The court concluded that when a lease requires a tenant to comply with the law during the term of the lease, that language does not require the tenant to bear the cost of code-compliance work required after the lease terminates.

Fourth Circuit affirmed damages of $31 million awarded to Lord & Taylor when a mall owner breached its lease agreement in connection with a planned redevelopment. *Lord & Taylor, LLC; LT Propco, LLC v. White Flint, L.P.*, Case No. 15-1995 (4th Cir. Feb. 28, 2017).

In 1975, when White Flint was developing the White Flint Shopping Center ("Shopping Center"), an enclosed shopping center in Maryland, Lord & Taylor agreed to lease land on the Shopping Center site as an anchor tenant, along with Bloomingdale's, and White Flint agreed to construct and operate a "first class" Shopping Center until 2042. White Flint was also required to obtain Lord & Taylor's consent prior to altering the Shopping Center's design or appearance.

In 2012, Bloomingdale's elected not to renew its lease, and by 2013, most Shopping Center tenants had vacated. In 2015, the Shopping Center officially closed, and Lord & Taylor was the only business operating at the Shopping

Center. By this time, White Flint was planning to redevelop the site into a mixed-use development.

Lord & Taylor brought a complaint against White Flint for damages resulting from White Flint's breach of contract, arguing that their agreement required White Flint to maintain the Shopping Center and obtain Lord & Taylor's consent to the redevelopment. Lord & Taylor sought damages for lost profits during construction of the redevelopment, for the costs of reconstructing its store, and for the loss of property rights, including use restrictions and easements violated by the redevelopment. The district court rejected Lord & Taylor's claim of damages for lost property rights, asserting that the proper measure of damages for the lost property rights is lost profits.

Lord & Taylor estimated that damages for lost profits during construction would be up to $31 million, due to disruptions of customer access and the reduction in foot traffic. White Flint posited that the damages would be significantly less, estimating a shorter construction period and lower profit margin, and including the profits that would accrue to Lord & Taylor once the mixed-use development became successful. The district court found such future profits to be too speculative, and instructed the jury accordingly. Lord & Taylor additionally presented testimony from a longtime executive handling renovations, who estimated damages between $30 and $36 million for reconfiguration of the store to be stand-alone rather than part of an enclosed shopping center.

The jury ultimately found that White Flint breached their contract, and awarded Lord & Taylor $31 million in damages, but did not specify the theory on which it awarded damages.

Both parties appealed to the Fourth Circuit, arguing that the damage award was either too high or too low. White Flint argued that the jury should have been instructed to consider Lord & Taylor's future profits and that a Lord & Taylor executive who testified regarding construction costs offered expert testimony without having been qualified as an expert under applicable rules of evidence. The Fourth Circuit affirmed the district court's holding, finding that White Flint had not established future profits with reasonable certainty, as required by Maryland law, and that the testimony of the Lord & Taylor executive was permissible as lay testimony because it was based on personal knowledge and his first-hand experience on the job. Lord & Taylor appealed the district court's rejection of its lost property rights claim, but the Fourth Circuit affirmed, stating that "loss of profits is the governing factor in calculating damages stemming from a violation of a restrictive use covenant," and allowing a plaintiff to recover for lost profits as well as lost property rights would amount to a double recovery. For a more detailed analysis of the case in the lower court, see the Fall 2016 issue of *Shopping Center Law & Strategy* entitled, "The Lord and Taylor Case: A Cautionary Tale for Re-development Projects."

Lenders

The Florida Supreme Court has ruled that a mortgagee was not precluded by the statute of limitations from filing a foreclosure action based on payment defaults occurring after the dismissal of the first foreclosure action but within the five-year period leading up to the subsequent foreclosure action. *Bartram v. U.S. Bank National Association,* No. SC14-1265, No. SC14-1266, and No. SC14-1305 (Fla., November 3, 2016).

Lewis and Patricia Bartram purchased the subject property on November 14, 2002, but they were subsequently divorced. Pursuant to a prenuptial agreement, Lewis Bartram was ordered by the divorce court to purchase Patricia Bartram's interest in the subject property. On February 16, 2005, Lewis Bartram obtained a $650,000 first mortgage loan on the property from an institutional lender, and on February 17, 2005, he granted a second mortgage to Patricia Bartram in the amount of $120,000.

The first mortgage was a typical institutional mortgage. In addition to providing acceleration and foreclosure as remedies for default, the first mortgage also granted the borrower a right to reinstate the note and the first mortgage after acceleration if certain conditions were met, including paying the mortgagee all past-due amounts and other related expenses.

Lewis Bartram stopped making payments on the first mortgage in January 2006, and he never made any payments on the second mortgage. In May 2006, the institutional lender accelerated the first mortgage indebtedness and filed a foreclosure action. In May 2011, the foreclosure action was involuntarily dismissed after the lender failed to appear at a case management conference. No explanation is given in the decision for the lengthy delay or for the lender's failure to appear.

In 2012, Lewis Bartram filed a cross-claim against the institutional lender in a separate foreclosure action that Patricia Bartram had filed with respect to the second mortgage. He sought to quiet title to the property, asserting that the statute of limitations barred the lender from bringing another foreclosure action on the first mortgage. The trial court agreed and granted summary judgment quieting title and canceling the note and the first mortgage.

Before the appellate court on appeal by the lender, the lender had acknowledged that while it could not seek to foreclose the first mortgage based on Bartram's defaults prior to the first foreclosure action, it argued that it could seek foreclosure based on defaults occurring after the dismissal of the first foreclosure action. Bartram argued that the cause of action for default of future installment payments accrued upon acceleration, thus triggering the statute of limitations clock to run. And, because the lender did not revoke its acceleration after the dismissal, the five-year statute of limitations period eventually expired, barring the lender from bringing another foreclosure action. The appellate court agreed with the lender, holding that "a default occurring after a failed foreclosure attempt creates a new cause of action for statute of limitations purposes, even where acceleration had been triggered and the first case was dismissed on its merits."

The Florida Supreme Court conducted a de novo review. The court recognized its own earlier precedent, which recognized that each new default presents a separate cause of action, based upon the acknowledgment that because foreclosure is an equitable remedy, mortgagees should not be precluded from remedies for multiple defaults on a mortgage. The court also concluded that the failure of a mortgagee to foreclose its mortgage based on an alleged default and, in this case, the fact that an earlier foreclosure action had been dismissed did not mean the mortgagor had automatically and successfully defeated the obligation to make continuing payments. In fact, the court concluded, the dismissal of the first foreclosure action returned the parties to their previous contractual relationship with the same continuing obligations:

> Bartram and the Bank's prior contractual relationship gave Bartram the opportunity to continue making his mortgage payments, and gave the Bank the right to exercise its remedy of acceleration through a foreclosure action if Bartram subsequently defaulted on a payment separate from the default upon which the Bank predicated its first foreclosure action. Therefore, the Bank's attempted prior acceleration in a foreclosure action that was involuntarily dismissed did not trigger the statute of limitations to bar future foreclosure actions based on separate defaults.

The Florida Supreme Court affirmed the appellate court's ruling in favor of the lender.

Sublease

The Texas Court of Appeals has ruled that a tenant had the right to assign or sublease parking spaces in connection with the sublease of office space pursuant to its lease without obtaining the landlord's separate consent to the assignment of parking spaces. *Two Briarlake Plaza LP v. Samsung Engineering America*, No. 01-15-01041-CV (Tex. App., November 1, 2016).

In 2012, Samsung signed a 12-year lease for approximately 160,000 square feet of office space in Two Briarlake Plaza in Houston, Texas. The lease allotted to the tenant four parking spaces for every thousand square feet of leased space.

Section 7 of Exhibit D to the lease provided as follows:

> Except as otherwise provided for in Section 14, Tenant shall not assign or sublease any of the [Parking] Spaces without the consent of Landlord. Landlord shall have the right to terminate the parking agreement with respect to any Spaces that Tenant desires to sublet or assign.

The court noted that:

> Paragraph 14.3 provides that Samsung may sublease office space to an affiliate of Samsung without Briarlake's prior consent. Paragraph 14.4 provides that a sublease of office space to a non-affiliated entity requires Briarlake's prior written consent. Paragraph 14.4 also sets forth the procedure by which Samsung obtains this consent and sets forth the grounds upon which Briarlake may withhold consent. The proposed assignment of parking spaces along with a sublease of office space is not grounds for withholding consent to a sublease of office space.

The parties filed competing declaratory judgment actions. The landlord argued that under Section 7 of Exhibit D, any assignment of parking spaces to a non-affiliate of the tenant would require the separate consent of the landlord, and that the landlord had an "unqualified right" to terminate the tenant's right to any parking spaces the tenant desired to sublet or assign.

Shortly after the declaratory judgment actions were commenced, the tenant sublet approximately 4,000 square feet of its space, and the sublease gave the subtenant the right to use four parking spaces per thousand square feet

subleased, corresponding to the ratio under the lease. After receiving a copy of the sublease, the landlord notified the tenant that it was terminating the tenant's right to the parking spaces purportedly assigned to the subtenant. The trial court ruled in favor of the tenant.

In reviewing the lease and the underlying decision, the court noted that "Section 14 does not expressly mention parking spaces." The landlord attempted to distinguish between an assignment or sublease to an affiliate and an assignment or sublease to a non-affiliate, but the court disagreed, saying:

> Parking spaces are not expressly referenced anywhere in section 14, but section 14 must implicitly permit assignment of parking spaces in connection with an office space sublease, or the reference to section 14 in paragraph 7 would be meaningless.

The court concluded that the tenant had the right to assign or sublease parking spaces in connection with the sublease of office space pursuant to section 14 without obtaining the landlord's separate consent to the assignment of parking spaces, and that the landlord's right to terminate the tenant's right to parking spaces would not apply in such circumstances. In other words, the termination right would only apply where the tenant attempted to transfer parking rights apart from a sublease or assignment of the lease. Accordingly, the court affirmed the trial court's judgment in favor of the tenant.

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