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Limiting landlord liability need not leave tenants unprotected.

People and Property: Exculpation Clauses in Occupancy Leases

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I KNEW THAT I shouldn't have moved as close to Harry's office as I did. Everybody warned me that he would make even more bizarre demands than he ever did before.

Who's Harry? If you have to ask, you aren't a loyal reader. But I'll tell you anyway. Harry Paine is a client. Actually, Harry's more than just a client, he's my number one client. This makes his health and prosperity my deep personal concern.

I was tired. I had been up all night to complete a memorandum for Harry on exculpation clauses in leases. The memo would help him prepare for an upcoming negotiation.

Harry called. He said he was upset. That was

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no surprise. Harry is always upset except when he is counting his rent checks or warming up for a mortgage closing.

I: What's wrong, Harry?

Harry: It's lost.

I: What's lost, Harry?

Harry: The $5 million check is lost, that's what!

The $5 million were the proceeds of the loan from Alfalfa National Bank for Harry's shopping center in Howe's Bayou, Louisiana.

Harry: I need that money to pay off suppliers. They've been threatening to sue. I need that money to pay off contractors.

I: Now don't get excited, Harry.

Harry: I need that check to pay you. I've been thinking that I owe you too much money.

I: Harry, you're right. This is terrible! We've got to find that check immediately. We'll look everywhere.

Harry: Stop screaming and get over here immediately. I want everybody here. The check must be found.

I: But, Harry, I'm working on the memo on exculpation clauses. You said you wanted it today.

Harry: I want that too. You'll finish it when you get home.

When I arrived at Harry's office, I found a mob of people. Everybody was there, both executives and staff. Normally, when Harry wants to exhibit his fury, we are assembled in the conference room. But since anyone—executive, secretary or adviser —could have misplaced the check, Harry spoke to us in the general office area where the secretaries' desks are located.

Did I say *spoke*? That's an understatement. He lectured, screamed, threatened, and called us names. I won't repeat the names because they were not very nice.

Despite our conscientious efforts and despite Harry's exhortations, the check still eluded us by early afternoon. When Harry summoned me to his office, my heart thumped. Was he going to blame me for losing the check?

"Where is the memo?" he asked. I rushed to my briefcase to get it, but it wasn't there. I was told to go home and get it immediately.

By the time I got home, it was 3:30 P.M. I raced to my desk and found nothing. The memo too was lost. Who would have taken it?

I lined up my wife, my daughter, and my son. I questioned them. I yelled, and I begged. We all looked for the memo, but it was nowhere.

At 5:00 P.M. Harry summoned me back to his office. When I told him I could not find the memo, he told me what I could do with it. He wanted me back to look for the check.

My wife and children promised that they would continue the search for the memo, while I went back to Harry's office.

A bit of good fortune occurred at 7:30 P.M. Marlene, Harry's secretary, found an old survey to Harry's country house. The survey was missing when Harry needed it six months ago. Since he was extremely upset about its loss then, we figured that finding the survey might calm him down.

But it only got him angrier. Now he shouted at the top of his lungs. Let me tell you, we were all frightened.

Harry's latest tirade was interrupted by the telephone. It was my wife, and she had good news. She had found the memo.

Before I tell you any more, I'd better let you read the memo. It might get lost again.

THE FUNCTION OF EXCULPATION CLAUSES

Lease exculpation clauses limit the liability of landlords. They are important to the landlord who holds a property in his own name or as a member of a partnership. These clauses are also essential to landlords such as real estate investment trusts or corporations that have substantial assets in addition to the real estate being leased. Such landlords wish to restrict their liability to the tenants, so that only the demised premises may be levied upon should the landlord default under the lease.

The justification for limited liability is relatively simple. A commercial or industrial tenant is seldom interested in the landlord's credit rating. In an existing building, once the commercial tenant verifies that the landlord owns the premises and that he hasn't bargained away any of his ownership rights by encumbering the property, the tenant's concern about the landlord's financial status usually ends. Tenants who sign leases for space in buildings yet to be constructed, should and sometimes do insist on some evidence that the landlord has sufficient funds to construct the project. But such tenants are concerned with the ability of the landlord

to produce the demised property, and their interest in his other assets is incidental.

Furthermore, commercial tenants are usually quite satisfied to enter into leases with corporate landlords whose sole asset is the project in which the demised premises are situated. If a tenant is willing to do business with such a corporate landlord, he should also be willing to do business with the individual landlord who seeks to limit his liability to the demised premises.

TAX CONSIDERATIONS ENCOURAGE PERSONAL OWNERSHIP

Now sit for a minute and ask yourself why a real estate operator or developer who would have no problem in getting a tenant to sign a lease with a dummy corporation would want to own the property in his own name and execute the lease personally as the landlord.

The reason is found in the nature of the income tax laws. Income from real estate held by a corporation is taxed at the corporate level, and the corporate dividends are taxed again on the shareholders' personal returns.[1] So landlords hold real estate in ways that avoid double taxation.

But there's another reason too.

The tax code offers real estate owners the delightful advantage of depreciation deductions. As you know, the depreciation deduction reduces taxable income, but it is not an out-of-pocket cash outlay. Depreciation deductions for real estate projects can shelter all of the revenue from the project. They can be so great that the project shows a loss for income tax purposes even while it yields substantial cash flow. When a corporation owns the real estate, the depreciation deductions go to the corporation, and the stockholders lose that advantage.

OTHER LANDLORDS ALSO NEED EXCULPATION CLAUSES

Landlords who are real estate investment trusts, partnerships, trustees, and trust beneficiaries need exculpation clauses for special reasons.

Although some states limit the liability of the owners of beneficial interests in real estate investment trusts, others do not. The trustees and the owners of beneficial interest in a trust would be shocked and surprised to find they are personally liable in a suit by a commercial tenant because of the trust's real or imagined default as a landlord.

The way to give the REIT trustees and owners of beneficial interests the protection enjoyed by corporate directors and shareholders is to limit their liability contractually by including an exculpation clause in all leases executed.

General partners of limited partnerships also depend upon contractual limitations of liability to insulate themselves from open-ended liability as landlords. Furthermore, unless the general partners' liability is limited contractually, the limited partners may lose important tax advantages.

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[1] The tax code does permit Subchapter S corporations to elect to be taxed as partnerships. But this advantage does not apply to corporations whose income consists primarily of rent.

When real estate is held in trust, both the trustees and the beneficiaries need exculpation clauses.[2]

SHOULD THE TENANT GET EXCULPATION TOO?

Some commercial tenants understand why the landlord's liability should be limited, but they argue that to be fair, the tenant should be exculpated too. What they mean is that the tenant's liability under the lease should be limited to the tenant's leasehold interest.

If the landlord went along with that idea and the tenant defaulted under the lease, the best that the landlord could do would be to evict the tenant. The landlord could not hold the tenant responsible for the rent payable after default or for the difference between the rent payable under the lease and the net proceeds of reletting. Such an arrangement really permits the tenant to pick up and leave at any time. A landlord would be in the same position as if he had leased a store or an office to a dummy corporation. Once such a leasehold is cancelled, the only thing a landlord can get is his premises (in whatever condition it might then be).

Although there are limited circumstances under which landlords are willing to enter into leases with dummy corporations, the practice could not become widespread unless the whole system of financing and exchanging commercial property were altered. Commercial mortgage lenders usually agree to lend in reliance upon the occupants' contractual lease commitment to a site. Purchasers of commercial real estate also look to the tenants' leases for their potential benefits. If tenants can leave the site without suffering any penalty, lenders might be expected to have little interest in making loans on the property, and prospective purchasers might be reluctant to buy.

Thus, to claim that it is only fair for both parties to a lease to have limited liability, leads to an untenable condition.

NEGOTIATING THE CLAUSE

There are two principal types of lease exculpation clauses. They parallel the comparable clauses used in mortgage forms.

One clause focuses on the assertion that the landlord has no personal liability at all; the other states that the liability of the landlord is limited to the landlord's interest in a specific asset.

Here is an example of an attempt to put both these concepts into the same clause.

> "Landlord (and, in case Landlord shall be a joint venture, partnership, tenancy-in-common, association or other form of joint ownership, the members of any such joint venture, partnership, tenancy-in-common, association or other form of joint ownership) shall have absolutely no personal liability with respect to any provision of this Lease, or any obligation or liability arising therefrom or in connection therewith. Tenant shall look solely to the equity of the then owner of the Demised Premises in the Demised Premises (or, if the interest of the Landlord is a leasehold interest, Tenant shall look solely to such leasehold interest) for the satisfaction of any remedies of Tenant in the event of a breach by the Landlord of any of its obligations. Such exculpation of liability shall be absolute and without any exception whatsoever."

I have used this clause when I have represented the landlord. But I believe the clause gives the landlord more protection than is appropriate, and I've been surprised at how few tenants' lawyers have proposed meaningful changes.

The clause presents the tenant with many problems. For example, the landlord's liability is limited to the "demised premises." Suppose the landlord has no interest in the demised premises in the first place? More than one landlord has executed leases in anticipation of buying a building or of buying the land and erecting the building.

[2] Real estate is held in trust routinely in a number of states, such as Illinois. The beneficiaries of these trusts, who play the same role as individual landlords do in other states, should insist on exculpation.

What happens if such a landlord does not buy the premises? When the tenant tries to enforce the landlord's obligations under the lease, and the landlord defends the claim on the grounds that the exculpation clause limits the landlord's liability to his interest in the premises, the court could be faced with a dilemma.

I can see one kind of judge dismissing the tenant's claim. On the other hand, I can also see another judge deciding that the parties could not have possibly intended that the landlord would be able to avoid all obligations to the tenant. Then by that magical process by which judges are able to discern intentions that were never expressed, he may conclude that the landlord has a whole lot of liability.

Once the tenant's attorney has ironed out this problem, his client may ask him to solve another. Most tenants in a shopping center accept the concept of exculpation, but they insist that the size of the landlord's liability should not be limited to the demised premises but should be enlarged so as to embrace an entire shopping center or industrial park in which the demised premises are located.

Landlords usually have no trouble in agreeing to this kind of modification to the exculpation clauses.

DEDUCTIONS FROM RENT

Many a tenant's lawyer thinks he has done his job by making sure that the landlord's liability applies to a piece of property larger than the tenant's leasehold. But there's more to the problem. Try this out for size!

If the landlord defaults under the lease, the proper (and only available) tenant action is to sue the landlord. Then if the tenant's claim is justified, the court will grant a judgment in the tenant's favor, and the tenant can levy against the assets described in the lease.

That would be a terrific idea if the landlord had substantial assets against which to levy. But it's not too useful when the landlord is a corporation whose sole asset is an industrial park that is mortgaged to the hilt. And it is not useful if the landlord is an individual holding a lease which contains an exculpation clause that limits his liability to a specific industrial park mortgaged to the hilt.

Thus, we have a conflict between the relatively modern concept of exculpation and the almost ancient notion that a tenant should pay its rent in full and on time even if the landlord is in default under the lease. However, there is a solution. The lease should permit a tenant to sue a landlord in default who has had an opportunity to cure and has not done so. If the tenant prevails in the lawsuit, the tenant should have the right to satisfy the judgment against his own future rent payments.[3]

This proposal stirs violent sentiments among certain landlords. They claim that with such a clause they could never mortgage their property. They're wrong and they probably know they're wrong. However, there are a few mortgage lenders who won't lend money to a landlord if the leases provide that the tenant can make deductions from rent.

IN CASE OF FIRE OR CONDEMNATION

Many commercial leases require the landlord to apply the proceeds of fire insurance and condemnation awards to the restoration of the demised premises.

One significant problem with popular forms of lease exculpation clauses is that if they are literally interpreted, they might permit the landlord to pocket fire insurance proceeds and condemnation awards even if the lease requires that they be applied to restoration.

A landlord whose liability under a lease was limited to its interest in a demised premises con-

[3] This approach obviously does not work in sale-leaseback situations or in other types of leases under which the tenant assumes the obligations which are customarily considered to be the landlord's burden.

sisting of a burned-down taxpayer on a relatively valueless plot of land might well prefer to grab insurance proceeds and take the chance that the tenant will grab the burned-down building. The landlord could just hold on to the money and refuse to comply with the obligation to restore.

This problem can, however, be handled without destroying the exculpation concept altogether. The lease merely must say something to the effect that the limitation of the landlord's liability does not apply to the landlord's failure to apply insurance proceeds or condemnation awards in accordance with the terms of the lease.

ESCROW FUNDS FOR TAXES

Owners whose mortgages require them to make monthly payments to an escrow fund to cover their liability for real estate taxes usually wish to pass this obligation to the tenants. In net lease transactions, the tenant is expected either to pay the real estate taxes on its premises or a pro rata share of the taxes imposed upon a larger premises. When a landlord is required to maintain a tax escrow fund, but his net lease tenants are responsible for the payment of these taxes, the leases may require the tenants to make payments to the landlord which he can use to satisfy his escrow payment obligation.

What if the landlord collects the money from the tenants and never makes the payment to the mortgagee? You may say that the tenant can sue the landlord to get the money back. But remember the exculpation clause. The landlord's liability is limited to his equity in the demised premises, and that equity may be nothing or next to nothing should the mortgagee foreclose.

Once again, a solution may be found by modifying the exculpation clause so that the limitation of liability does not apply to the misappropriation of escrow funds.

A SOUND EXCULPATION CLAUSE

When you're all finished negotiating you might end up with a clause that looks like this.

> "In case of default, breach or violation by Landlord of any of Landlord's obligations under this Lease, other than a failure to apply insurance proceeds, escrow funds or awards in accordance with the terms of this Lease, Landlord's liability to Tenant shall be limited to its ownership interest in the Shopping Center or the proceeds of a public sale of such interest pursuant to foreclosure of a judgment against Landlord. Landlord may relieve itself of all liability under this Lease other than liability for failure to apply insurance proceeds, escrow funds or awards in accordance with the terms of this Lease by conveying the Shopping Center to Tenant. Notwithstanding any such conveyance, Tenant's leasehold and ownership interest shall not merge."

SOLVING THE MYSTERY

Now back to Harry's office. My wife was still on the telephone.

I: You found the memo? Where was it?

Mrs. Halper: First I have to tell you *how* I found it.

I: Please don't tell me *how* you found it. Just tell me *where* you found it.

Mrs. Halper: Well here's *how* I found it. First, I thought about who might have handled the memo. There were only two possibilities. You and the cleaning lady. We had looked in all the places you might put something. Then I figured that it must have been the cleaning lady.

First I tried the clothes closets, then, the pantry closet. Still no sign of it. Then I refined my method. I asked myself where I would have put it if I were the cleaning lady. It was in the vase on your desk.

I: Incredible, fantastic. That's the key! Now I know how to find the check.

Mrs. Halper: I know that. That's why I had to tell you my method.

And now all that was necessary was to use the method. Who could have had the check to start with? Harry obviously brought the check to the office. One of his characteristics is a magnetic attraction to legal tender. Another characteristic is to delegate all responsibility. And so it was easy to surmise that he had given the check to Marlene, his secretary, with instructions to deposit it. Where would a girl like Marlene put a check?

It struck me. I ran to Marlene's desk, seized the trash basket, and dumped its contents on the floor.

Marlene was infuriated and wanted to know how I'd like it if she turned over my garbage can. She started crying and went in to complain to Harry.

Meanwhile I sat down on the floor and calmly sifted through Marlene's trash.

There were about fifteen empty packets of Wash n' Dry, an old pair of shoes, about ten crumpled tissues, part of a hamburger, yesterday's newspaper, an unopened box of ball-point pens, and a check for $5 million.