

Managing legal considerations during a commercial holdover

In this highly competitive commercial leasing market, both landlords and tenants are finding themselves faced with the increasingly common pressure of timely building-out new space, decommissioning former space, and physically moving entire businesses, with the risk that delays may cause a tenant to holdover its expiring lease term. While it is common to contractually allocate or mitigate this risk among a landlord and tenant in a lease agreement, landlords often find themselves tied to two tenants simultaneously concerning the same premises, between an outgoing and an incoming tenant, which are both contractually bound to the landlord, but not to each other. This unique scenario, where three parties have an interest in real estate, but lack complete privity among each other, can give rise to potential liability which may not be addressed in the parties' respective agreements. For this reason, it is critical for anyone facing a commercial holdover to be aware of the legal issues that present themselves, which may not be readily discernable. This article will provide a brief overview.

An often-overlooked legal consideration is a holdover tenant's potential liability to an incoming tenant, based in tort law. Specifically, an incoming tenant may assert a claim against a holdover tenant for tortious interference of contract (i.e., the incoming tenant's lease), based on the holdover tenant preventing the incoming tenant from taking possession of the premises pursuant to the new lease, due to the wrongful holdover of the outgoing tenant. Appellate courts have upheld this type of tortious interference of contract claim, finding that a holdover tenant becomes a "trespasser" once that tenant holds over and fails to timely surrender the premises to the landlord. Notably, since an incoming tenant and a holdover tenant are not in privity of contract, there is no contractual limitation on the amount of damages which the incoming tenant may seek. This can include pecuniary loss of the benefits of the lease, including potential lost profits and other consequential damages resulting from the tortious act, and possibly punitive damages, depending on the circumstances.

Landlords entering into new leases commonly protect themselves from liability to the incoming tenant resulting from their inability to timely deliver possession by requiring the incoming tenant to contractually waive direct damages and consequential damages which the incoming tenant may sustain from any delays and limiting an incoming tenant's remedies to some modest rent abatement or the right to cancel the lease if the delay is too lengthy. For this reason,

Legal Viewpoints

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an incoming tenant that incurs substantial loss as a result of a tenant holding over in its space would have reason to seek its damages from that outgoing tenant.

Landlords have an obvious incentive to vacate a holdover tenant, since the prospect of long-term cash flow from an incoming tenant is much more attractive than having a vacant space and defending against a claim for brokerage fees resulting from the lease that the incoming tenant elected to terminate. However, a landlord's interests can become conflicted if the outgoing tenant's lease contains a "holdover clause" that obligates the outgoing tenant to pay rent during the holdover period at a rate equivalent to two or three times the fixed rent in the lease. This could amount to a windfall for the landlord, where the landlord is contractually protected from liability to the incoming tenant, while collecting a substantial fee from the outgoing tenant, which is often characterized as liquidated damages. Accordingly, a landlord's strategy can tactfully weigh considerations such as the fair market value of the space relative to the holdover rent, the landlord's timing to compel a vacatur through legal process, and how long a landlord can string the incoming tenant along.

Here, however, is where a landlord needs to navigate carefully. If a landlord accepts holdover rent from an outgoing tenant, without pursuing possession or otherwise preserving its rights and remedies against it, the landlord can be found to acquiesce to the holdover tenant remaining in possession, especially if a holdover clause would seemingly permit a holdover tenant to do so. This may absolve the holdover tenant of any tortious liability to the incoming tenant, since the holdover tenant and landlord are acting in compliance with the otherwise expired lease. This, in turn, may limit the incoming tenant's claims for damages to only those which may be asserted against the landlord. Therefore, a savvy outgoing tenant may look to induce the landlord into accepting a holdover, while paying a higher holdover rent, because it would afford the holdover tenant with protection against the incoming tenant's tort claims.

In this way, a holdover tenant paying a little more rent to a landlord as liquidated damages under a holdover clause can insure itself against much larger consequential damages claims stemming from its delays relocating into new space. This can turn the tables on a short-sighted landlord, which may find itself violating the covenant of good faith and fair dealing to the incoming tenant, notwithstanding any contractual protections that the landlord may have reserved for itself in the lease.

Alternatively, the outgoing tenant may challenge its liability to the landlord for holdover rent as liquidated damages. A liquidated damages clause will only be enforced by the court if the amount liquidated bears a reasonable proportion to the probable loss and the amount of actual loss is incapable or difficult of precise estimation. However, if the amount fixed is plainly or grossly disproportionate to the probable loss, the provision calls for a penalty and will not be enforced. If there is any doubt as to whether the provision is an unenforceable penalty or a proper liquidated damage clause, the court will resolve it in favor of viewing it as an unenforceable penalty. As such, a holdover tenant is not without defenses of its own against its landlord, if it needs to holdover.

Of course, this all assumes that the outgoing tenant is creditworthy or that the outgoing tenant has other economic concerns, such as a guaranty or a security deposit that it wishes to retain. Many times, the outgoing tenant is a single-purpose entity without any assets and, therefore, may be "judgment-proof" as to any liability for damages. This would put even greater pressure on a landlord to timely recover possession and decommission the outgoing tenant's space which the outgoing tenant may want to otherwise seek to delay without peril.

In light of the numerous legal considerations at issue during a commercial holdover, the parties are wise to make these critical decisions with the guidance of legal counsel as soon as it becomes evident that there may be a holdover. More often than not, tenants who need to holdover will have counsel in place before the lease term ends, without the other parties becoming unaware of it. Landlords, in particular, must be careful not to unwittingly prejudice their position, since it is the only party contractually bound to the other two and it is ultimately the landlord's burden to vacate the outgoing tenant and deliver the space to the incoming tenant. Having experienced counsel available throughout this eventuality is invaluable.