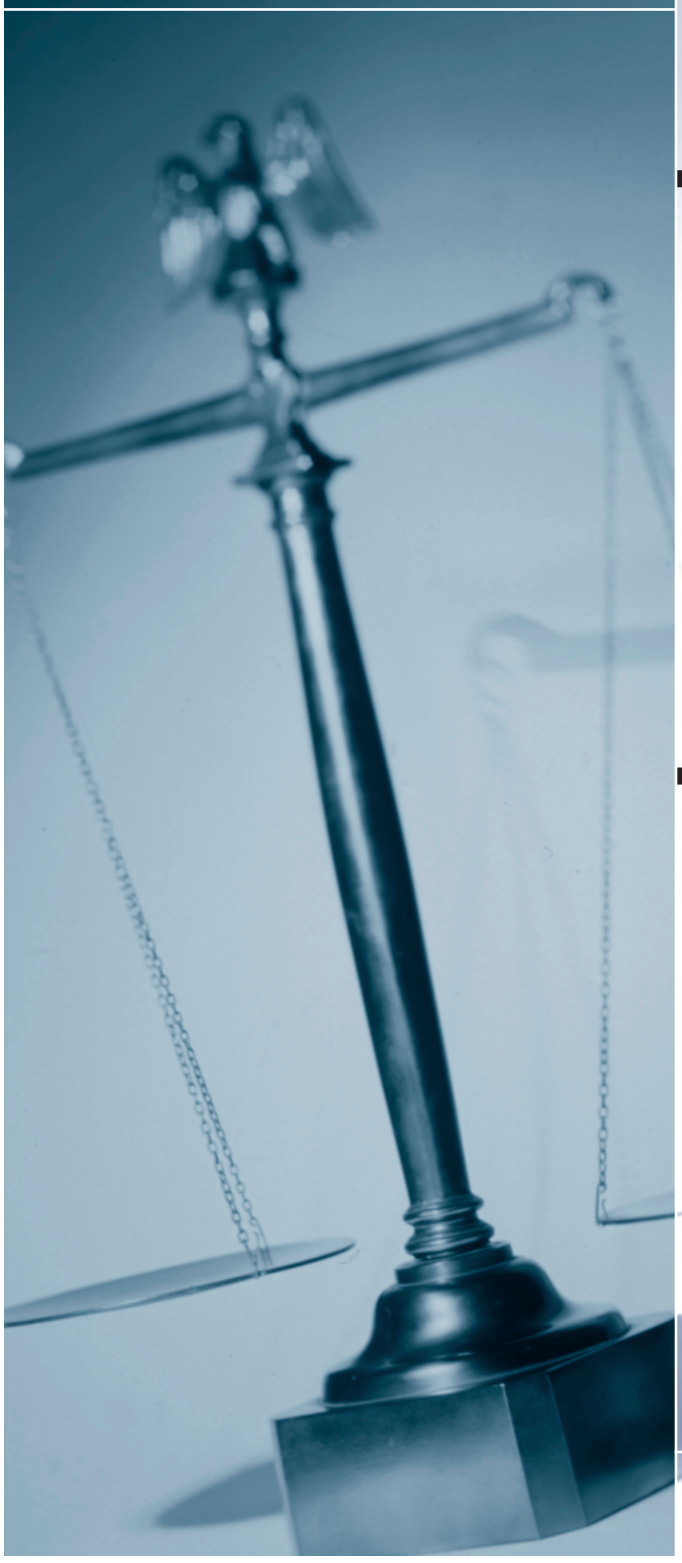
VOL. 25 ISSUE 1 SPRING 2005

International Council of Shopping Centers, Inc.
1221 Avenue of the Americas, 41st floor, New York, NY 10020-1099
Phone (646) 728-3800

Shopping Center Legal Update

The legal journal of the shopping center industry



'Good Faith and Fair Dealing' in Optionland

Joshua Stein
Latham & Watkins LLP
New York, New York

If a tenant unambiguously tries to exercise an option but doesn't get it right because of an obvious misinterpretation of the words of the lease, does the landlord need to say anything? Or can the landlord sit back, wait for the exercise deadline to lapse, and then laugh at the tenant (and the tenant's counsel) for having gotten it wrong?

A January 2005 New Jersey Supreme Court case, *Brunswick Hills Racquet Club, Inc.* v. *Route 18 Shopping Center Associates*, 2005 N.J. Lexis 7, concluded that the landlord has an obligation to tell the tenant about its mistake, and give the tenant a chance to try again and exercise the option correctly. The court reached that result by applying the "implied covenant of good faith and fair dealing." However, the court did so against a backdrop of a particularly egregious and unfortunate set of facts—a peculiar history so unusual and distasteful that the decision may end up being limited to its own facts.

Brunswick Hills Racquet Club may ultimately have little practical impact on future litigation about defectively exercised options. Nevertheless, the case certainly does give the hordes of unfortunate tenants that bring such litigation another line of authority that they can, and undoubtedly will, cite. In any event, the case teaches tenants and landlords, and their counsel, some important lessons about how to draft and exercise options in leases.

In *Brunswick Hills Racquet Club*, a tenant leased part of a shopping center, with a fixed-price option to extend the lease or purchase the leased premises by giving notice by a certain date. The lease required the tenant to include a check for $150,000 with the notice. The option price turned out to represent a great deal for the tenant and a correspondingly disastrous deal for the landlord.

The tenant without doubt tried to exercise the option 19 months before the deadline—but forgot to include a check. For the next 19 months, the tenant's counsel tried to set up the details and final documents for the closing pursuant to the option. The landlord's counsel took its time in answering the tenant's counsel's letters. Any letter to the landlord would be forwarded to the landlord's counsel for review, which would take a few more weeks, and any letter to the landlord's counsel would fall into an abyss while the landlord reviewed it. The parties' counsel exchanged letters, and occasionally discussed the format for closing documentation. The landlord managed to have the tenant chase its tail for 19 months, never once suggesting to the tenant or its counsel any defect in the notice of exercise.

The option exercise deadline finally came and went. Soon after that, the landlord's attorney "dropped the hammer," by saying that the tenant had never validly exercised the option, because the notice of exercise did not include a check for $150,000. The landlord was right. The lease unambiguously required the tenant's exercise notice to include a check for $150,000, but the landlord had never said a word about the omission during the 19 months between the date the tenant tried to exercise the option and the date the option expired.

Two lower courts ruled for the landlord, concluding that the tenant bore the burden of exercising the option correctly and that the landlord had no obligation to help out. The New Jersey Supreme Court reversed. The Supreme Court decision began by recognizing that commercial real estate transactions are "highly competitive," taking place in a world where "sophisticated business entities operate according to the impersonal laws of the marketplace in which self-interest, not altruism, is the dominating principle." *Brunswick Hills Racquet Club*, at *10. Parties need to take care of themselves. The New Jersey Supreme Court expressed the general principles of contract enforcement and interpretation as follows:

> [The tenant] did not abide by the strict terms governing the exercise of the option and, ordinarily, would suffer the consequences of its default. Courts generally should not tinker with a finely drawn and precise contract entered into by experienced business people that regulates their financial affairs. Equitable relief is not available merely because enforcement of the contract causes hardship to one of the parties. *Brunswick Hills Racquet Club*, at *27.

The court then proceeded to do exactly what it said that courts do not do. The court reviewed the particular facts of this case, and concluded that the landlord's silence amounted to a breach of the landlord's obligation of "good faith and fair dealing" under general contract law. The court decided that the landlord did have an obligation to tell the tenant about its mistake, and hence the court allowed the tenant to rectify the mistake even after the option period had expired.

The court recognized that "good faith" amounts to a "concept that defies precise definition." *Brunswick Hills Racquet Club*, at *28. Passing up an opportunity to refer to Justice Brennan's definition of pornography, the court stated: "We cannot catalogue the myriad forms of conduct that may constitute a violation of the covenant of good faith and fair dealing. Each case is fact-sensitive." *Id.*, at *30. The court noted that any claim of breach requires a showing of a "bad motive or intention," *Id.*, at *29. The court found it by concluding that the landlord lulled the tenant into complacency, leading the tenant to "rel[y] on the presumed good faith of [the landlord] to [the tenant's] detriment." *Id.*, at *33. (Of course, this construction assumes its conclusion, by accepting the notion that good faith required the landlord to tell the tenant about its mistake.)

The court concluded that the landlord had engaged in a 19-month "pattern of evasion," in which the landlord "sidestepp[ed] every request by [the tenant] to discuss the option and ignoring [the tenant's] repeated written and verbal

entreaties to move forward on closing . . . ." Given the tenant's persistent efforts to move forward with closing the deal, the court said that the landlord bore some obligation to notify the tenant of the mistake it had made in exercising the option.

The court paid lip service to the notion that sophisticated parties to commercial transactions must look out for themselves, but then stated:

> [A]s our good faith and fair dealing jurisprudence reveals, there are ethical norms that apply even to the harsh and sometimes cutthroat world of commercial transactions. Gamesmanship can be taken too far, as in this case. We do not expect a landlord or even an attorney to act as his brother's keeper in a commercial transaction. We do expect, however, that they will act in good faith and deal fairly with an opposing party. [The tenant's] repeated letters and telephone calls to [the landlord] concerning the exercise of the option and the closing . . . obligated [the landlord] to respond, and to respond truthfully.
>
> In concluding that [the landlord] violated the covenant [of good faith and fair dealing], we do not establish a new duty for commercial landlords to act as calendar clerks for their tenants. We do not propose that attorneys must keep watch over and protect their adversaries from the mishaps and missteps that occur routinely in the practice of law. . . . [The landlord] acted in total disregard of the harm caused to [the tenant], unjustly enriching itself with a windfall increase in rent at [the tenant's] expense. In the circumstances of this case, [the landlord's] conduct amount to a clear breach of the implied covenant of good faith and fair dealing. *Id.*, at 39–40.

(The court labels the potential benefit to the landlord as a "windfall." If, however, the tenant fails to satisfy the option procedures but still gets the benefit of what later turns out to be a bargain price, this apparently does not constitute a "windfall" for the tenant.)

The court emphasized the egregious nature of the facts of this case. It quoted cases warning against the wide-open and potentially unlimited scope of a judge-made covenant of good faith and fair dealing and proclaimed that it did not intend to create "potential pitfalls" that undercut the reliability of any words in any contract. *Id., at* 40. The court simply concluded that this landlord's actions in the context of this set of facts violated the covenant. (The court could have reached the same result much more narrowly. The court could have said that when the landlord and its counsel gave the tenant the impression that they were working toward a closing —albeit very slowly—the landlord had through its conduct implicitly accepted the tenant's exercise of the option, and waived strict compliance with its terms. That would have been enough to decide the case.)

Can the *Brunswick Hills Racquet Club* case and its broad reading of the "implied covenant of good faith and fair dealing" be limited to its own particular facts? Perhaps. And perhaps not. One can now assume that every time a tenant incorrectly exercises an option (and it seems to happen a lot!), the tenant will argue that the "implied covenant of good faith and fair dealing" requires the landlord to cut the tenant some slack. Every such tenant will try to argue that the landlord bears some implied obligation to help the tenant realize the error of its ways, and give the tenant a second chance to do a better job of exercising the option. The burgeoning jurisprudence on defective exercises of options will burgeon some more.

One might also argue that tenants are categorically less sophisticated than landlords, and typically less able to afford the proper legal work necessary to assure that tenants exercise options correctly. These theories would say that courts should cut tenants some slack and not apply the words of leases in a literal and mechanical way that deprives tenants of benefits that they reasonably expected. Tenants and their counsel should not, this argument goes, be expected to live up to every technical detail. Close enough should be good enough. This may, in fact, represent the trend of the law. It may prevent unpleasant surprises for tenants, but at the cost of creating a tremendous incentive to litigate every mistake in exercising an option (at a cost far exceeding the attorney fees saved earlier in lease administration).

Of course, even if the courts decide to welcome and encourage such litigation, every tenant and its counsel should do what they can to avoid it, both in negotiating leases and in exercising options when the time to do so arrives.

When negotiating a lease, a tenant can sometimes persuade the landlord to agree to give the tenant a reminder notice before any option expires. Perhaps the notice should even remind the tenant of exactly what the tenant needs to do to exercise the option (e.g., include a check). Of course, the same tenants who will forget to exercise their options properly are also the same tenants who lack the negotiating strength to require the landlord to give a "reminder notice."

Along similar lines (and subject to the same practical limitation), a tenant might insist that if the tenant ever tries to exercise an option, the landlord must acknowledge receipt of the exercise notice, acknowledge that it is valid and notify the tenant within some short time if the landlord believes the notice is in any way invalid (much like the notice that a letter of credit issuer must give if the issuer intends to deny payment).

Tenants and their counsel might also reconsider whether options are worth the risks. They might, for example, negotiate a longer lease term with an option to terminate, although such an option raises all the same issues about the technicalities of proper exercise.

Once a tenant obtains an option, the tenant should make a record of it and remember to think about it long before the option exercise deadline. Counsel can play an important role here by making appropriate entries in a "tickler" file, so that counsel will remember to notify the tenant six months or a year in advance. Counsel will, however, typically want to avoid incurring an affirmative obligation to remember the option.

Tenant's counsel may also want to prepare a separate memo summarizing the terms and timing of the option and the procedure to exercise it. The best time to prepare such a memorandum would be shortly after the parties sign their lease, while memories are fresh. And the parties and their counsel should keep the memo with the lease, to increase the chance of finding it when the time comes.

Once a tenant decides to exercise an option, it should make sure to do it correctly. Here are a few points that any tenant should consider:

- Exercise the option well before the deadline, to leave time to do it again if the first time didn't work correctly.
- Read the lease. Don't assume that it says what you expect it to say.
- Comply with the specific notice procedures, requirements and addresses in the lease. If you know they're outdated (but haven't been officially replaced), comply with them anyway, and also send the notice to any other known address for the landlord.
- After exercising, request an estoppel certificate to confirm the exercise (if the lease requires broad estoppel certificates), or rely on a "further assurances" clause to request a confirmation that the option was exercised.
- Don't assume that the tenant's lawyer can exercise the option on the tenant's behalf. Exactly such an exercise occurred in *Brunswick Hills Racquet Club*, and no one made an issue of it. Some cases suggest that an attorney has no power to give any notices for his or her client. *See, e.g.*, *Siegel* v. *Kentucky Fried Chicken*, 501 N.Y.S.2d 317, 318 (1986) where the tenant "was entitled to ignore" notices from the landlord's attorney "as not in compliance with the lease provisions concerning notice," which required notice from the "landlord." Although this rule may amount to an exercise in "hypertechnicalism," would the notice from the attorney bind his or her client if the client decided after the fact that the client didn't really want to have given the notice? If the attorney's notice can't bind the client, why should it bind the other side?
- If the landlord seems to act evasively or dilatorily in implementing the exercise of the option, consider starting litigation earlier rather than later, to flush out whatever theories and claims the landlord might have about the exercise of the option. (Ideally, leave plenty of time to litigate before the option exercise deadline.)

Some of the preceding suggestions may be more realistic than others. However, they all teach a single important lesson: Tenants and their counsel should bring to options and their exercise a level of care, concern—and perhaps obsessiveness—even paranoia—that some other areas of leasing do not require. Tenants and their counsel should remember that options are almost by their nature guaranteed to be contentious.

JOSHUA STEIN negotiates, closes and helps administer major leasing and financing transactions from coast to coast. This year, ALI-ABA will publish his fifth book, a guide to ground leases. Copies of many of the author's previous publications are available at www.real-estate-law.com.