

LITIGATION DECISIONS IN COMMERCIAL REAL ESTATE LEASING

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Abstract

This article introduces dispute resolution and litigation models for commercial real estate leasing. The concepts and models developed in the article can also be applied to equipment leasing and other types of leasing.

Keywords: Decision analysis, litigation strategy; complexity; commercial real estate leasing; equipment leasing; Risk Management

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Introduction

Real estate leases are complex long-term incomplete contracts that require simultaneous, continuous and phased performance, and different types of monetary and non-monetary performance by typically unrelated parties. The lessee's propensity to comply with lease terms at specific times is greatly influenced by economic conditions, lessee's resources, and the various costs that may be incurred by the lessee and lessor upon breach of the lease agreement.

Existing Literature

The existing literature on leasing includes the following: Albert & McIntosh (1989); Bartell (1998); Bernfeld (Fall 2002); Coloma (2001); Garmaise & Moskowitz (2003); Ge, Yang, Proudlove & Spring (2004); Ghyoost (2004); Kangoh (1995); McNally, Klein & Abrams (2001); Miceli, Sirmans & Turnbull (2001); Mooradian & Yang (2002); Pretorius, Walker & Chau. (2003); Sebenius (1992). Benjamin, Jud & Winkler, 2000). (McNally, Klein & Abrams, 2001); Pretorius, Walker & Chau (2003); Triantis & LoPucki (1994); Michael (2000); Heyes, Rickman & Tzavara (2004); Katz (1990); Triantis (1993).

The existing literature on leasing in the real estate industry is extensive, but the materials don't analyze some of the following issues:

1. The optimal conditions for a lease.
2. The optimal lease, and the optimal Rent.
3. The effect of 'incompleteness' of leases on economics of such leases.
4. The choice between leasing and borrowing.
5. The choice among a sale-leaseback or no-action, or borrowing.
6. The analysis of commercial property leases as part of the supply chain for retailers and medium/large companies. Location is

crucial for retailers. Real estate rents often accounts for more than 30% of the operating expenses of retailers; and more than 15% of operating expenses of other types of companies.

7. The analysis of commercial leasing as a dynamical system.
8. Analysis of commercial property leases as Take-Or-Pay contracts.

The literature on litigation choices and dispute resolution is extensive and includes the following:

Cooter & Rubinfeld (1989); Png (1983); Heyes, Rickman & Tzavara (2004); Cooter & Rubinfeld (1989); Png (1983); Lambert (1983); Palfrey & Romer (1983); Zhang et al (1998); Beckner & Katz (1995); Holm (1995); Dnes (1995); Babcock, Farber, Fobian & Shafir (1995); Elwy, Nasr, Hamza, et al (1996); Braun & Kahan (1996); Pooles, Simon, Nicholas et al (1997); Garcia, Ducheyne, Boettiger & Jost (1997); Klement (2003); Hatzis (2002); Hylton (2002a); Parisi (2002); Polinsky & Rubinfeld (2002); Crew & Twight (1990); Rubin, Curran & Curran (2001); Benson (1993); Fon & Parisi (2003); Fon, Parisi & Depoorter (2005); Boari & Fiorentini (2001); Hylton (2006a); Hylton (2006b); Hylton (2007); Hylton (2002b); Hylton (2003); Arruñada & Andonova (2004); Ramey & Watson (2002); Shavell (1995); Priest & Klein (1984); Drahozal (2004); Rhee (2006); Drahozal (2005); Hylton (2000); Hylton (2005); Shavell (1982); Lumineau & Oxley (Sept. 2007); Scott & Triantis (2006); Sanchirico (2006).

However, there is very little research on dispute resolution in real estate leasing. The following are the existing gaps and omissions in the existing literature on dispute resolution as it pertains to leasing and real estate leasing:

1) Leases are incomplete contracts. Most of the studies and theories of litigation focus on defined situations and complete contracts.

2) Unlike most of the contracts and situations analyzed in existing studies, Leasing disputes often involve significant sunk costs; leasing disputes often involve various types of executory, present and future ownership interests.

3) The advent of various forms of credit enhancement has created more uncertainty but greater flexibility with regard to the tax and accounting criteria for litigation and dispute-resolution choices.

4) Most property leases include choice-of-forum and choice-of-law clauses which affects transaction costs, compliance costs, propensity-to-litigate and willingness-to-comply.

5) Unlike many situations, litigation decisions in commercial real estate leasing are constrained by concerns about reputation and social capital.

6) Unlike many disputes, property Lessors' and Lessee's Insurance policies often don't cover litigation costs that arise from leasing.

7) Real estate leasing and real estate don't follow any known probability distributions – hence, its error to use probabilities in analysis of litigation decisions in leasing.

8) Most real estate leasing disputes don't involve punitive damages or tort claims. Most of the existing literature on litigation decisions are applicable in situations that involve punitive damages, and torts.

9) Most real estate leasing disputes involved capped damages, and or damages that can be easily calculated from lease data, tenant improvement data and leasing commissions data.

10) Unlike many litigation situations, the effect of a single real estate leasing dispute: 1) on the local market is minimal, 2) on the specific property – greatly depends on the type of property, the nature of the lease interest (eg. leasehold vs. estate-for-years, etc.), and the size of the leased space,

11) In real estate leasing, the opportunity costs of litigation are less than in most other litigation situations.

12) In most commercial real estate disputes, the lessor and lessee are both corporate entities that are typically well capitalized, and can afford litigation. Hence, the sensitivity of the prospective litigant's wealth to Propensity-To-Litigate is low; and the sensitivity of the prospective litigant's Propensity-To-Settle to its wealth, can vary widely.

13) Unlike most litigation situations, leasing involves 'place-value' (value of a particular location to the lessee) and emotional-value (to lessee). These two behavioral tendencies tend to affect lessees' and lessors' Propensity-To-Litigate and Propensity-To-Settle.

14) Most of the studies focus on selection of disputes for litigation based on 'ex-post' conduct; whereas in many instances, the choice of litigation alternatives is affected by 'ex-ante' conduct such as arbitration and forum-selection clauses.

15) The "asymmetric information" model is inaccurate because a) in many instances, asymmetric information does not always translate into

higher/lower win rates – other factors such as legal precedent, advocacy ability, evidentiary rulings, social capital, etc. affect win rates, the propensity to litigate and the propensity to settle the disputes. In commercial real estate leasing disputes, the 'asymmetric information' model is

Structure Of Leases

The leasing process is essentially a four-stage dynamical system because: 1) the various components and relationships in the lease-system vary over time, 2) there is a clear network of relationships among distinct parties, which are defined by the lease contract, the Uniform Commercial Code, the Bankruptcy Code, custom and state laws, 3) factors that affect one component of the lease system tend to affect other components of the system and the value of the relationships among the various components. See: Beer (2000); Dellnitz & Junge (1999); Moore (1991); Friedman & Sandler (1996); Evans (1998); Agarwal, Bohner, O'Regan & Peterson (2002); Iacus (2001); Van Gelder (1998); Tucker (1997); Treur (2005); Hojjati, Ardabli & Hosseini (2006); Kaiser & Tumma (2004); Schultz (1997); Chehab & Lamine (2005); Sebenius (1992); Xu (2005); Vasant, Nagarajan & Yaacob (2005); Bisdorff (2000); Corbett, DeCroix & Ha (2005). The components of the system include: a) lessor, b) lessee, c) broker, d) county clerk (where leases are recorded), e) banks and financial institutions – that finance leases, f) credit enhancement vendors (eg. FGIC, FSA, etc.), g) the Lease Agreement, h) any encumbrances on the subject property, i) the subject property; i) laws and regulations. The various stages of the lease-system are as follows:

a) Stage one – the decision to lease.

b) Stage two – finding a tenant and negotiating and signing the lease.

c) Stage Three – performance of the lease.

d) Stage Four – any default or non-performance of lease terms, up until lease expiration.

The typical lease provides the lessor with periodic (quarterly or semi-annual) property inspection rights in order to monitor property conditions. Many existing commercial real estate leases are 'incomplete contracts' because they: 1) are triple-net leases, 2) have overage clauses, 3) the performance obligation is not capped/limited or clearly defined. Mooradian & Yang (2002). Gross leases are much more complete than Net-leases because they contain more specific and definite terms, and less exposure or uncertainties. Due to financial difficulties experienced by US retailers between 1995-2004, it was expected and natural that many retailer-tenants would seek to reduce the fixed portions of rents, and to increase the 'overage' or variable portions of rents. Bernfeld (Fall 2002). Brickley (1999); McCann & Ward (2004); Tse (1999); Pretorius, Walker & Chau (2003); Pashigian & Gould (April 1998); Hansmann & Kraakman

(2000); Mejia & Benjamin (2002). The effect of such ‘incompleteness’ in lease contracts can be substantial and depends on location, retailers’ brand name, tenant marketing efforts and transaction costs (costs of re-leasing the space, litigation costs, lost sales revenues, etc.). From the lessee’s perspective, the sources of incompleteness are:

1. Operating expenses – maintenance, insurance, premises liability not covered by insurance, etc.
2. Overage rents
3. Capital expenditures
4. Premises liability
5. Natural disasters
6. Landlord’s efforts in marketing the shopping mall.
7. Probability of adequate remedy for breach – suitability of pre-specified forum for resolution of disputes.
8. Lessee’s Employee’s effort levels at that location –
9. Lessee’s intensity of utilization of space.
10. Lessee’s Assignment or sub-letting rights, where Lessee must obtain lessor’s permission before any assignment or sub-leasing.
11. Presence or absence of hazardous materials in the site – where lease is a NNN lease – and the extent of lessee’s liability for environmental cleanups.

Litigation Models

Let:

α = other ‘monitoring costs’ incurred by the landlord for lease appraisals, reviews of filings, etc., in order to ensure compliance with lease terms.

β_T = post-default ‘cure costs’ incurred by the lessee. In some instances, minor defaults occur because the lease terms are so many and onerous.

β_L = ‘cure costs’ incurred by landlord if lessor does not seek other remedies and is willing to negotiate.

λ_T = post-dispute pre-litigation costs that the lessee incurs in connection with the lease.

λ_L = costs that the landlord incurs to comply with lease terms in order to avoid further litigation or to settle a dispute – these costs are incurred before there is resolution activity (ie. arbitration, court litigation or mediation) and include negotiation costs, attorney fees, transaction costs, etc..

Ψ_T = post-default ‘remedy costs’ that the lessee pays. These costs are incurred when there is some dispute resolution activity (arbitration, court litigation, or mediation) and include litigation costs, accrued rent and interest, engineering and consultants’ costs, payment of necessary fees/expenses such as insurance and taxes, etc..

Ψ_L = ‘remedy costs’ which the landlord incurs typically to cure prolonged defaults of leases terms – these costs are incurred when there is some dispute resolution activity (arbitration, court litigation, or mediation) and include litigation costs, accrued rent and interest, engineering and consultants’ costs, payment of necessary fees/expenses such as insurance and taxes, etc..

γ_L = “remedy” benefits that the landlord gets upon settlement or termination of the dispute – such

benefits include accrued rent, costs of assigning the lease or subletting the space to another tenant, reimbursement of litigation expenses, and other accrued expenses such as utilities, maintenance and taxes.

π_L = **damages that the landlord gets** if it wins in court or arbitration proceedings.

π_T = damage awards that the lessee gets if lessee wins in court or arbitration proceedings.

κ = ‘performance costs’ incurred by the lessee in order to perform entire terms of the lease.

ξ = “supervisory/rationalization costs” - while most corporate/franchisee tenants typically treat each store as an operating entity in terms of performance evaluation and capital allocation, the corporate tenant typically incurs “supervisory/rationalization costs” to ensure compliance with all lease terms and to determine where or not to close or relocate stores.

θ = The economic value that the landlord gains from lessee’s performance of all lease terms.

t = time horizon for evaluation. $t \in H$, where H is the lease term.

Specifically, the lessee will always comply with lease terms so long as Lessee knows that the following conditions exist:

1. $\int_0^t (\Psi_T + \kappa + \lambda_T) \partial t > \int_0^t (\kappa + \xi + \beta_T) \partial t$
2. $\partial \beta_T / \partial \kappa > \partial \lambda_T / \partial \kappa > \partial \Psi_T / \partial \kappa > 0$
3. $\partial \beta_T / \partial t > \partial \lambda_T / \partial t > \partial \Psi_T / \partial t > 1$
4. $\partial \beta_T / \partial \Psi_T > \partial \lambda_T / \partial t > \partial \Psi_T / \partial t > 1$

The landlord will be willing to negotiate instead of litigating lease defaults iff the following condition exists:

$$(5) \quad \left[\int_0^t (\theta - \alpha - \lambda_L) \partial t > \int_0^t (\theta - \Psi_L - \lambda_L + \gamma_L - \alpha) \partial t \mid \int_0^t (\Psi_T + \kappa + \lambda_T) \partial t \geq \int_0^t (\kappa + \xi + \beta_T) \partial t \right. \\ \left. (\Psi_T + \kappa + \lambda_T) > \text{Max}[(\kappa + \xi + \beta_T), 0] \right]$$

(6) The landlord will be willing to negotiate instead of litigating lease defaults if:

$$\left[(\theta - \alpha - \lambda_L) > \text{Max}[(\theta - \Psi_L - \lambda_L + \gamma_L - \alpha), 0] \mid [(\Psi_T + \kappa + \lambda_T) \geq \text{Max}\{(\kappa + \xi + \beta_T), 0\}] \right] \quad (7)$$

Note that in Equations (6) and (5), the decision to litigate or settle is distribution-free (completely independent of either party’s estimates of probability of prevailing in court/arbitration proceedings and expected damage awards). This approach is somewhat different from existing models of litigation and dispute resolution, for several reasons. Each party’s decisions can be made based on existing information because performance and terms are clearly defined. Most contract breaches are not tortuous and thus, do not involve the award of large damages other than contractual damages. The adjudicator’s remedy can be predicted with some measure of accuracy because lease terms are relatively straightforward. On the other hand, judges and juries may not follow expected patterns of decisions, and damage awards vary depending on the circumstances of each case.

In this instance, asymmetric information has several dimensions:

a) The lessee has more information about its prospects and its ability to perform lease terms – in such information has minimal value primarily because of the validity of lease agreements, expectations of contractual performance, and established remedies and possible existence of credit enhancement such as letters of credit.

b) Either party may have more information about real estate market conditions and the possibility of finding another tenant for the space at the same or higher rent – in this instance, such information also has minimal or no value because of existence of established remedies for default, variations in rents in real estate markets, and the typical difficulty in confirming potential tenants.

c) Either party may have different opinions and or more information about the outcome of any prospective litigation.

Conclusion

Commercial Real Estate Leasing remains a major source of capital in various industries, such as healthcare, retailing, telecommunications, manufacturing, agriculture, energy and financial services. Real estate constitutes a substantial portion of fixed assets (land, buildings/fixtures and lease interests), capital expenditures, loan assets and operating costs (maintenance, insurance, taxes, rents and depreciation) in these industries. The selection of leasing disputes for litigation is somewhat different than most other circumstances. The analysis of litigation choice must be independent of assumptions of probability distributions.

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