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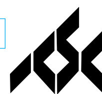

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Shopping Center Legal Update

The legal journal of the shopping center industry

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The Green Shopping Center—A Landlord or Tenant Endeavor

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Shopping centers around the globe are turning green, and not just for branding purposes. The same argument to build or retrofit sustainable buildings for commercial properties holds for shopping centers. Sustainable buildings typically benefit from lower operating expenses,[1] less potable water consumption,[2] potential tax credits and other incentives,[3] better indoor environmental quality,[4] higher worker productivity and fewer sick days,[5] and public relations benefits from a mandate to embrace corporate responsibility.

A shopping center can employ the same sustainable building design concepts that any other type of building uses. These would include, without limitation:

- Rooftop HVAC[6] units using full outdoor air economizers to reduce the need for cooling when outdoor air is cool
- Solar and wind power to help meet its energy needs
- Regenerating heat from the refrigeration racks
- Radiant floor heating
- Burning waste-recycled cooking and motor oil to heat water
- LEDs (light-emitting diodes) instead of incandescent or fluorescent light bulbs
- Green roofs with drought-resistant vegetation
- Reusing treated water, captured from rooftops and parking lots, for irrigation purposes
- Use of reflective roofs
- Use of low VOCs[7] such as those found in sealants, paints and furniture.
- Minimization of light pollution with exterior wall-mounted fixtures in the parking lots to promote "dark-sky" and minimize upward lighting
- Addition of a heat exchanger to minimize spring and winter cooling requirements from the chiller and the inclusion of a system of water flowing from the cooling tower back into the chiller, converting it into chilled water
- Commissioning and re-commissioning of all systems
- The use of BAS,[8] which turns off equipment during low load and unoccupied times
- Using indoor photocells connected to the lighting control systems so that the lights turn off when the natural light level exceeds a base level
- Individual tenant-controlled HVAC units
- Green cleaning
- Green pest control
- Automatic flush urinals, toilets, sinks
- LED digital screens with shopping center maps to avoid the printing of paper

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The benefits of going green abound—not only in direct economic cash-on-cash terms, but also in indirect ways. Studies have consistently shown that employees in a sustainable building take fewer sick days per year than their counterparts in non-green buildings.[9] Furthermore, employee productivity is a by-product of occupancy in a green building. In a recent Notre Dame study, it was reported that bank employees are more productive in a sustainable premises. "Over the years, there have been lots of studies that show employees are more satisfied and productive when they work in green buildings, but this is the first study to show that banks actually bring in significantly more revenue. Researchers found that bank branches generate more revenue—$461,300 per employee—even though they offer the same products and services as others." Clearly, shopping center developers now have many carrots, albeit green ones, to entice retail tenants to their malls. But do retailers themselves want to embrace sustainability?

In fact, within the past ten years, many retailers have gone green. This can be found not only in the corporate mandates of behemoths such as Wal-Mart,[10] Tesco, Kingfisher, Starbucks, Safeway, Nike, Intel, Dow, Whole Foods and Kohl's, but also in their actions. In 2011, the Corporate Renewable Energy Index was developed to show how corporations are investing in renewable energy through Renewable Energy Certificates ("RECs"); green pricing; carbon offsets; and direct investments in solar, hydro, wind, geothermal and others.[11] But energy savings is only a part of the story.

Whole Foods, for example, recognizes that reducing the use of potable water is also an important component in sustainability programs. In its "Whole Foods Market's Green Mission 2012," the company boasts its use of low water landscaping, rainwater harvesting, and automatic water faucets.[12] Similarly, Nike has green building practices for some of its retail stores.[13] In the Houston Niketown store, for example, not only did Nike reduce energy and water consumption, but it touts that "96 percent of construction waste was recycled and low-VOC paint and finishes were used throughout" the store.

So, if the retailers are jumping on the sustainability bandwagon, which shopping center owners are doing likewise? Abroad, there are now many mall owners that have already turned green: The Taj Mall (Amman, Jordan), the Ir Yamim Mall (Netanya, Israel), the Mall of Split (Split, Croatia) and the Erzurum Shopping Center (Erzurum, Turkey). In the United States, there are many more: Melaver, Inc. (Abercorn Common, Savannah, GA); Pyramid (Destiny USA, Syracuse, NY); Crescent Real Estate Holdings LLC (The Shops at Houston Center and 4 Houston Center, Houston, TX); Bond Companies (Springbrook Prairie Pavilion, Naperville, IL); Regency Centers (Deer Springs Town Center, North Las Vegas, NV); Jefferson Square (La Quinta, CA); Lower Nazareth Commons (Township, PA); and Taubman Centers, Inc. (City Creek Center in Salt Lake City, UT).

Although not all shopping centers obtain some form of certification[14] when turning green, many have some form of green certification. For example, certified centers in the United States and Canada include: Abbotsford Shopping Centre (Abbotsford, British Columbia), CashCo Pawn and Shopping Center (San Diego, CA), Ft. Polk Shopping Center (Ft. Polk, LA), Langley Shopping Centre (Langley, British Columbia), Pedro Point Shopping Center (Pacifica, CA), Waikiki Shopping Plaza Expansion (Honolulu, HI), The Mall at Millenia (Orlando, FL), Prime Outlets Phase VII (Williamsburg, VA), Tanger Outlet Center at the Arches (Deer Park, NY), Northfield Stapleton (Denver, CO), Tanger Outlet Center Hilton Head I (Bluffton, SC), Green Circle Shopping Center (Springfield, MO).[15]

Once a shopping center owner or its tenant decides to have a sustainable property/premises, there are some legal issues that each of them should consider when becoming green. For example, each contract to be executed by the mall owner or tenant planning to obtain sustainability (and perhaps certification as well) will need to reflect the intent of all those signing the agreement and their respective obligations under it. Similarly, myriad parties are involved in the greening process (which includes not only getting to a green status, but also maintaining that green status). Each party must strictly adhere to its contractual obligations because the landlord or tenant (or both) has a lot riding on sustainability.

The following case study is offered to better explain what could happen if the contracts turning a property green are not well-drafted.

Case Study

In our hypothetical, ABC Centers LLC ("ABC") is expanding its shopping center with a second phase ("Phase II") and will retrofit the existing portion ("Phase I") so that the entire center ("Center") will become LEED Gold Certified. The first contract that ABC signs is with its architect ("Architect"), who will design the new Phase II and the Phase I retrofit. The architectural firm guarantees LEED ("Leadership in Energy and Environmental Design") Gold Certification of the shopping center against its attorney's advice) on or before a date that is 18 months after execution of the contract with ABC (all references to timing for the project are based on the original date of execution).

Two issues raise potential red flags. One is the guaranty of completion, which, in and of itself, poses problems. The second issue is the guaranty that the certification will be obtained by a date certain. Since the USGBC ("United States Green Building Council") through its certification body GBCI ("Green Building Certification Institute") is the certifying body, the process is totally out of the control (at least with respect to timing) of the architect.

ABC next contracts with the one who will perform the retrofit designed by the architect—namely, the contractor ("Contractor"). Here, although not requiring the contractor to guaranty the certification from GBCI, the contract permits ABC to withhold its final installment of payment for the work until certification is obtained, which could be many months after substantial completion of the job. The Contractor promises substantial completion no later than the 15th month.

ABC next enters into a loan agreement with a lender ("Lender") to pay for the construction.

In order for ABC to pay its debt service, ABC signs a 20-year lease with an anchor tenant for Phase II ("Retail"). The 20-year lease, which also gives the tenant four 5-year renewal options, is for 50,000 rentable sq. ft. of space in a LEED Gold Certified shopping center. The lease was to commence in the 24th month.

Lastly, ABC, which uses a property manager ("Property Manager"), modifies its existing contract with the Property Manager to include (for an added fee) having the Property Manager oversee the construction of Phase II, the retrofit of Phase I and the obtaining of LEED Gold Certification for both.

The Problem

Although the Contractor substantially completes the entire job by the 15th month, the Center's application for LEED Gold Certification had problems with it. As of the 18th month, the Center had not yet achieved LEED Gold Certification. ABC was told by a representative from GBCI that a Silver Certification (*not Gold*) would be issued in or about the 24th month—but no sooner.

The Domino Effect

Now the fun part begins. The lease between ABC and Retail required ABC to deliver to Retail the premises (which you remember had to be in a LEED Gold Certified center) no later than in the 20th month—or else Retail had one of the following options:

- To terminate the lease, ***or***
- To be given 1/3 credit in monthly rent for the entire term if LEED Gold Certification was not delivered at commencement or, if lost during the term, from the date of the loss of certification through either the date certification was granted or the expiration of the term (including all renewals). If Retail chose this option, Retail had to take occupancy no later than the 21st month, ***or***
- To take occupancy in the 21st month with a ½ monthly rent credit until LEED Gold Certification was delivered and maintained or if a lower certification level was delivered (such as Certified or Silver) on or before the 20th month.

By the way, on top of all of this, the loan agreement between ABC and Lender required that ABC deliver a LEED Gold Certified Center on or before the 20th month or it was an Event of Default under the loan agreement. Lender could, in addition to other remedies, withhold its last construction loan payment until Gold Certification was obtained.

Furthermore, if LEED Gold Certification was not achieved on or before the 24th month, the Lender could foreclose on the loan.

Well, the fun continues. The 20th month rolls around, and there is no LEED Gold Certification. In fact, no certification is evident at all. ABC still owes the Contractor its last payment and owes Architect its final payment. And, although the lease provided for Retail to notify ABC no later than the 20th month as to which option Retail would exercise, there has been no word from Retail. The Property Manager has contacted Retail repeatedly, but gets no response.

Who Sues Whom?

ABC sues the Architect for failure to deliver a LEED Gold Certified Center by the 18th month. The Architect countersues ABC for failure to pay its fee, and blames the failure of issuance of the LEED Gold Certification on ABC's change orders during construction—which substituted a green building product with a non-green product.

ABC sues the Contractor for substituting a non-green product into the construction job without ABC's consent, which proximately caused the failure of LEED Gold Certification to be issued. The Contractor countersues ABC for failure to pay its fee and blames the failure of issuance of the LEED Gold Certification on ABC for not responding to the requested change order; also, the Contractor sues the Architect for not providing guidance on a substitute green product when the original products were unavailable.

ABC next sues Retail for not exercising its option under the lease because ABC needs to know (a) if it has a tenant at all or (b) under what economic scheme the tenancy will be structured. Retail countersues ABC because ABC knew, or should have known, that LEED Silver Certification was the most it could obtain for the Center; if only ABC had given Retail notice of this earlier, Retail could have terminated the lease and rented space across the avenue from ABC's shopping center from another, older, LEED Gold Certified mall for the same rent it was to pay ABC.

Circumstances have now changed. Market conditions have improved for the across-the-avenue shopping center owner (which now has no LEED Gold competitor across the avenue), and the rent there is 1½ times the rent under ABC's lease with Retail. Retail seeks damages in the amount of the difference for the entire 40 years it might have rented space from ABC.

Next, the Lender has decided to call the failure to obtain LEED Gold Certification a material default under the loan ("Event of Default") and to foreclose on the loan. ABC defends itself by stating that the foreclosure is premature, because it is not yet the 24th month and no certification has been issued. Although GBCI stated that LEED Silver Certification is the most it would award to ABC, there was a chance it could be LEED Gold instead. ABC also contends that the loan agreement was ambiguous, notwithstanding that the language in the loan agreement permits the Lender to withhold the last construction

loan payment "until LEED Gold Certification is obtained." ABC asserts that the Lender should wait as long as it takes until LEED Gold Certification is issued.

Lastly, ABC sues the Property Manager for negligently supervising the construction job and failing to obtain LEED Gold Certification.

* * *

As one can see, the road to sustainability could be laced with many obstacles and liabilities. To better protect themselves in contracting and in getting what they are paying for, shopping center owners and retail tenants should be cognizant of all the legal issues that could arise.

What is the long-term outlook for getting shopping centers to go green? Clearly, on just an operating expense reduction basis, there are few reasons not to embrace as many sustainable building modifications as possible. If one adds in the intangible benefits of going green—higher worker productivity, fewer sick days and lower healthcare costs, all of which relate to indoor air quality, green cleaning, green pest control and more—smart mall operators should do everything they can to get green. Retailers who rent space from them will be demanding it, not only for their own bottom lines, but also with the general public demanding these sustainable initiatives.

In her insightful article, "Five Reasons for Retailers to Go Green," Karen Lowe sums it up best. "Building a sustainable supply chain, conserving energy, developing smarter packaging, becoming more socially responsible, and developing more loyal customers"[16] are "worth the investment." Clearly, many large and small retailers agree.

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[1] See http://www.gsa.gov/graphics/pbs/Green_Building_Performance.pdf.

[2] See http://www.jccegov.com/greencommunity/what-is.html, which states that "Green Buildings Consume 40 Percent Less Water than non-green buildings.

[3] See, for example, http://www.nyserda.ny.gov/ for listings of New York State incentives.

[4] In green buildings, indoor air quality is typically much better. See http://www.greenbuilding.com/knowledge-base/indoor-air-quality for a good explanation.

[5] See http://www.workforce.com/article/20111115/NEWS02/111119986/employees-breathing-easier-in-green-buildings, showing that indoor air quality is a recipe for high productivity and few sick days.

[6] Heating, ventilation, air-conditioning equipment.

[7] "VOC's, i.e., volatile organic compounds, are chemicals used in many products that are released into the air and are harmful to humans.

[8] Building Automation System.

[9] See *Businessweek* Magazine, Dec. 7, 2009, "The Dividends From Green Offices," 2.9 fewer sick days per year in a sustainable building. Also see a Jan. 2012 Michigan State University study, reporting 40 fewer sick hours taken per year in a green building.

[10] For example, see http://walmartstores.com/sustainability/, where Wal-Mart's corporate sustainability Web page touts that the "broad environmental goals at Wal-Mart are simple and straightforward: to be supplied 100 percent by renewable energy; to create zero waste; to sell products that sustain people and the environment."

[11] See for example, the following company reports from Wal-Mart: http://www.sustainablebusiness.com/index.cfm/go/news.display/id/22613, Whole Foods: http://www.wholefoodsmarket.com/pdfs/2012MarchGreenMissionReport.pdf, Nike: http://www.nikebiz.com/crreport/, and J. Crew http://www.jcrew.com/flatpages/social_responsibility_procurement.jsp?FOLDER%3C%3Efolder_id=2534374302048661

[12] See http://www.wholefoodsmarket.com/pdfs/2012MarchGreenMissionReport.pdf

[13] *Id.*, the Nike Houston store was built to LEED-CI (commercial interiors) certification standards.

[14] Such as from G.B.C.I. (under the U.S.G.B.C.), GBI, Energy Star, Ashrae, BOMA.

[15] See http://www.usgbc.org/LEED/Project/CertifiedProjectList.aspx and http://www.usgbc.org/LEED/Project/CertifiedProjectList.aspx

[16] See http://www.stores.org/stores-magazine-january-2009/five-reasons-retailers-go-green.

Making Projects Financeable by Using Federal Historic Tax Credits

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Introduction
As practitioners, it is important to be knowledgeable of the many incentive program opportunities available so that we can guide and assist clients in making the most of their investments. For those development projects that face challenges and difficulties, creative use of incentive programs may make the project achievable. This presentation will highlight certain federal incentive programs that address the goal of preserving historic structures and reclaiming obsolete buildings for productive reuse.

Benefits from incentive programs are often increased where the resourceful practitioner can find ways to use federal incentives in combination, working with multiple layers of conventional and publicly assisted financing. The incentives may make the difference in making the project financeable by:

- Making available lower-cost equity investment for otherwise marginal projects, with the investor contributing capital to the project in exchange for tax credits and with the tax credits assuring the investor will have the desired return on investment.
- Improving the financial position of the developer and the project by reducing project costs and improving project cash flow. The result is improving the return on investment in the project.
- Reducing the cost of capital for the project, by reducing interest costs through sources of low-interest loans.

Federal Historic Rehabilitation Tax Credits
1. Brief Background Summary
The federal Historic Rehabilitation Tax Credit (“HRTC”) program was originally enacted as part of the Revenue Act of 1978 and has undergone modification in subsequent tax legislation. It is one of the oldest economic development programs supported by the federal government. The HRTC program is codified in § 47 of the Internal Revenue Code (“IRC”). The HRTC program is administered by the National Park Service (“NPS”) in partnership with the Internal Revenue Service and the historic preservation offices in each state. The HRTC program serves as an indirect federal subsidy aimed at incentivizing the rehabilitation of historic and older buildings. It provides a dollar-for-dollar offset to federal income liability, as it is a credit against taxes owing and not a tax deduction.

The HRTC is a national program available in every state. It is not limited by geography or the income level of the community. Any location can qualify—urban or rural—so long as the proper steps are taken to qualify the building or structure for the program. According to estimates of the National Trust for Historic Preservation, this tax credit program has fostered the private sector rehabilitation of more than 31,000 properties and stimulated more than $31 billion in investment nationally.[1]

2. What Is HRTC?
The HRTC program includes two levels of credits: a 20% tax credit for structures that qualify as “certified historic structures” and a 10% tax credit for buildings constructed before 1936 that do not have the “certified historic structure” designation. To qualify for either credit, the project must meet four criteria:

1) The IRC requires the building to be “depreciable”—that is, the building must be used in a trade or business or held for the production of income.
2) The IRC requires that rehabilitation must be “substantial,” which means that over a 24-month measuring period,[2] the “qualified rehabilitation expenditures” (or “QREs”) must exceed the greater of $5,000 or the adjusted basis of the building (the “substantial rehabilitation” test).[3] § 47(c)(1)(C).
3) The subject building or structure must qualify for the program. For the 20% credit, the building must be designated as a “certified historic structure,” achieved because the building itself either (a) is listed in the National Register of Historic Places or (b) is located within a “registered historic district” listed in the National Register of Historic Places[4] and certified by the National Park Service as a structure contributing to the historic significance within the registered historic district and (c) the building is not used *exclusively* as the taxpayer’s place of residence. § 47(c)(3). To qualify for the 10% credit, the property must be a non-residential[5] building placed in service before 1936, and the building itself cannot be listed in the National Register of Historic Places.[6] The listing of the National Register of Historic Places by state and county can be found at **www.nationalregisterofhistoricplaces.com**.
4) For the 20% credit, the plans and specifications for the rehabilitation work must be pre-qualified through the procedures of the NPS such that the work can be designated “qualified rehabilitation expenditures.” For the 10% credit, there is no formal review or application process for the rehabilitation work and design.

3. How Does HRTC Work?
To qualify for both levels of HRTCs, the taxpayer must make application to the NPS; the application is submitted through the historic preservation office of the state in which the property is located ("SHPO").

The first step in the process for the 10% and the 20% credit is the review of the proposed structure that is to be rehabilitated, to assure that the building is eligible, and the Part 1 application is submitted to SHPO. The SHPO provides the necessary applications, coordinates with the NPS and guides the taxpayer through the application process for designation as a certified historic structure; or for the 10% credit, confirmation that the building is not a certified historic structure. The taxpayer must pay to the NPS an application fee for this designation.

The second step for the 20% credit is the review of the proposed rehabilitation work to be performed on the historic structure to assure that the work meets the requirements, and the Part 2 application is submitted to SHPO along with detailed architectural plans and drawings. The project work must meet certain standards to be designated as "certified rehabilitation" by the NPS. A certified rehabilitation is a rehabilitation project for a certified historic structure that has been approved by the NPS "as being consistent with the historic character of the property and, where applicable, the district in which the structure is located." 36 CFR § 67.2(b). The NPS follows certain rehabilitation standards found in 36 CFR 67, and will not certify any rehabilitation project that damages, destroys or covers materials or features defining the structure's historic character, whether exterior or interior.

The safest approach is to obtain approval from the NPS of the Part 2 application before the building is placed in service. At a minimum, the taxpayer must have a "reasonable expectation that the NPS determination will be granted."[7] The HRTCs can be claimed in the tax year in which the project is placed in service. For phased projects, the HRTC is allowed before the rehabilitation is complete, as long as the project meets the substantial rehabilitation test described above. The HRTC is subject to a carry-back of one year and a carry-forward of 20 years, and may be recaptured unless the owner (or long-term lessee) maintains ownership of the historic structure for five years following completion of the project.[8] In addition, the IRS has promulgated certain regulations regarding the depreciation and the depreciable basis of the rehabilitated property.

Once the Part 2 application is filed and the rehabilitation is underway, only certain expenditures can be counted as "qualified rehabilitation expenditures." These are basically expenditures properly chargeable to the capital account for real property, which can be depreciated under §168 of the Code. § 47(c)(2). In addition to the typical construction hard costs, HRTC eligible costs can include architectural, engineering and surveying fees; legal expenses; development fees; and other costs "if such costs are added to the basis of the property."[9] Certain costs and expenses are not qualified expenditures, such as property acquisition costs, furniture and equipment, costs of additions or other new construction, and costs of ancillary improvements (e.g., parking lots, sidewalks and landscaping).

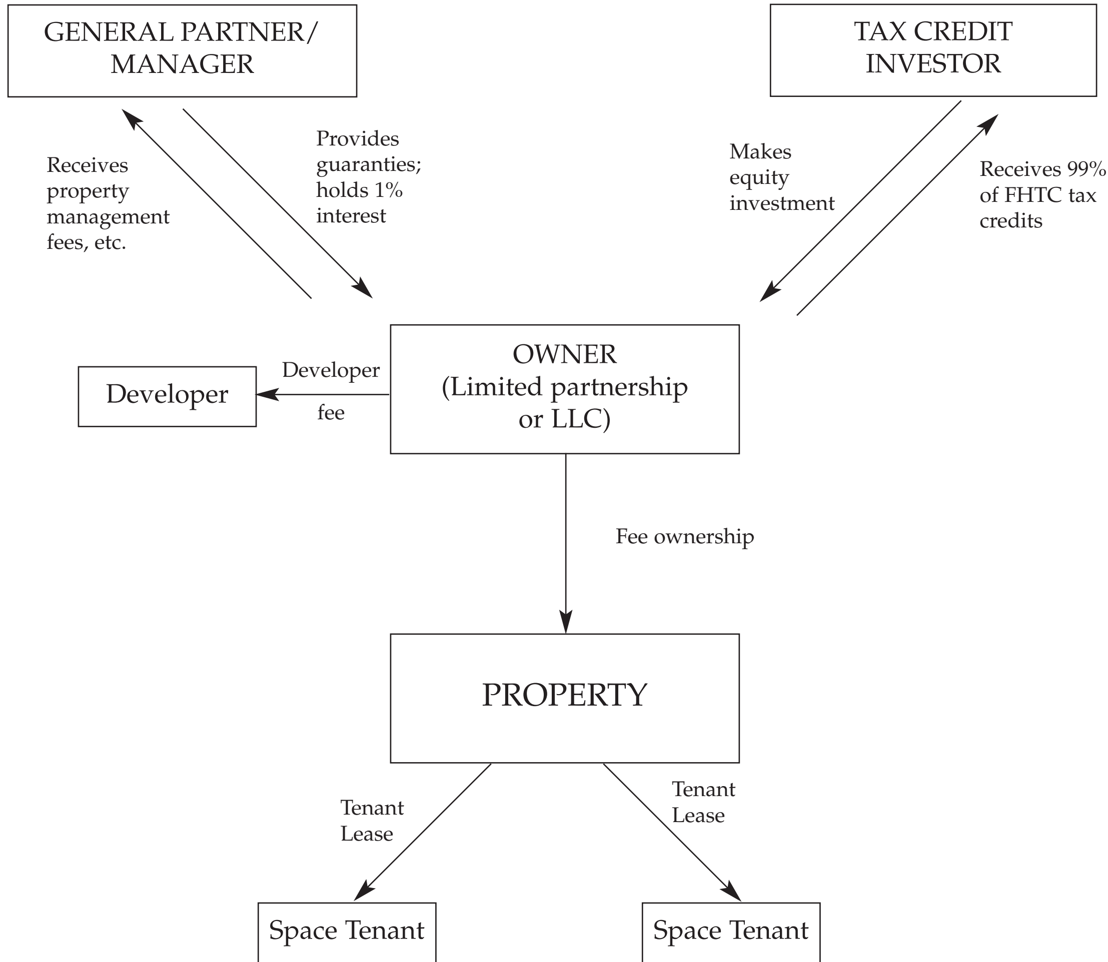
4. Who Can Use the HRTC Program?
Property owners and tenants under long-term leases may apply for the HRTC program. To qualify for the tax credit, the rehabilitation work must be performed on behalf of the party applying for the credit. Further, the rehabilitation work must be paid for by the party applying for the tax credit and that party must claim the depreciation for that property on its federal tax return.

The benefit of the tax credit may be transferred to a tax credit investor in exchange for an equity investment in the property owner entity or the tenant entity. HRTCs are attractive to individuals and corporations that have substantial federal tax liability, and participation may be direct or through an investor entity. Banks and other financial institutions are among the regular participants in the program. In addition, there are some investors such as Chevron U.S.A. Inc. and Kimberly-Clark Corporation that have specialized in HRTC investing. The HRTC program is also attractive to banking institutions because participation helps in meeting their Community Reinvestment Act ("CRA") requirements.

Structuring the Property Owner for an Historic Rehabilitation Project
To take advantage of the HRTC program, the tax credit investor has to have an ownership interest in the property owner entity or the tenant, and the tax credits will be allocated to the investor in accordance with the investor's ownership rights. Under the property ownership structure often used, the property is owned by either a limited partnership or a limited liability company (the "Partnership") in which the project developer acts as general partner or manager and the tax credit investor acts as limited partner or non-managing member. Figure 1 below illustrates this property owner structure. Under federal income tax rules, a partnership is not a taxpaying entity; rather, the partners pay tax on their ratable share of partnership earnings or are entitled to their ratable share of partnership tax credits. Under this structure, the project developer can have full management control over the project, can retain a substantial portion of the economic benefits of the project and can still allocate a substantial portion of the HRTCs to the tax credit investor.

HRTCs must be allocated in accordance with the profit interests of the partners of a Partnership on the date the qualified rehabilitation expenditures are placed in service. Accordingly, in order to receive 99% of the credits, the tax credit investor must be admitted to the Partnership and have a 99% interest in Partnership profits on the date the building is placed in service, and must remain so invested for at least the five-year compliance period for the HRTCs. Thereafter, it may be possible to reduce the profit interest of the investor from 99% to a lower number. It should be noted that while 99% of the profits must be allocated to the tax credit investor, the project developer may find other means to reduce the profits of the Partnership by diverting property revenues to the project developer under other agreements. The project developer may be

FIGURE 1
Investor/Property Owner Entity Structure



paid a developer fee equal to approximately 15%–20% of the other costs of the rehabilitation of the project. Property management fees and other related fees may be paid out of project revenues to affiliates of the developer.

Master Lease Structure

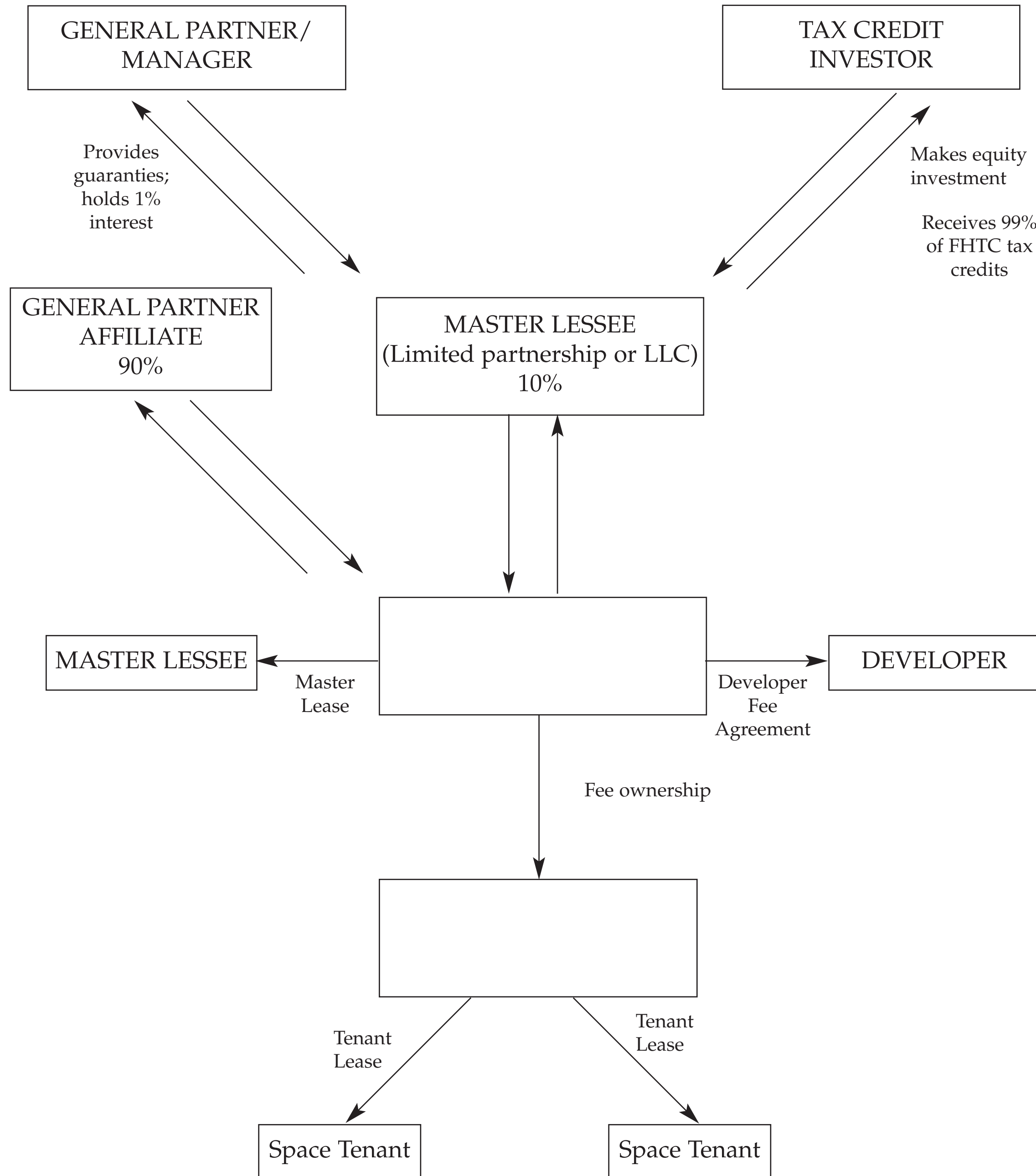
Most typically, the parties structure HRTC transactions using a master lease arrangement that allows the investor to obtain the tax credit benefit while being shielded from liability for on-going property operations. The entire property will be leased to a master tenant that is owned 99%–100% by the tax credit investor, but managed by the developer. Figure 2 below illustrates this master lease structure, as typically used in HRTC deals. The property will, in turn, be subleased to the space tenants as the end users of the property. Any profit derived from subleasing the project at a rental rate in excess of the master lease payments will be retained by the project developer. Care has to be taken to structure these arrangements on terms comparable to transactions with arms-length pricing.

The master tenant will be admitted as a minority member of the property owner entity, and the property owner agrees to pass through the HRTCs to the master tenant when the property owner earns the tax credits by completing the rehabilitation work. There will be industry-driven documentation required for the special-purpose entity that serves as the property owner and the master tenant, spelling out the specific ownership interests and rights of the developer and investor. Also, there will be prescribed leasing and subleasing agreements and operating agreements. Typical documents are attached as exhibits to this presentation, illustrating the master lease format and the tax credit pass-through agreement. Attached to your presentation will be a closing checklist showing the wide range of documents included in a typical HRTC transaction using the master lease format.

Other Structuring Issues

While the tax credit investor maintains a passive role with respect to operations, the investor will insist on certain protections in the event operations fail or the property needs operating cash. Most likely, the protection for the investor will be the right

FIGURE 2
Master Lease Tax Credit Pass-through Structure



to step in and change the management of the property owner and the master tenant and thereby direct property operations. The tax credit investor will want to avoid changing the ownership structure of the property owner or the tenant, given that such a change creates the risk of recapture of the HRTCs. Careful efforts are taken to avoid triggering recapture during the five-year compliance period for the HRTC program.

Further, the investor will typically insist on certain guaranties from the developer or a creditworthy entity associated with the developer, and the guaranties will cover financial liability for project completion and project operations during the five-year compliance period, as well as the buy-out or "exit strategy" once the HRTCs are vested. The guaranties address the investor's principal concern that the project remain a viable operation for the five-year compliance period. Accordingly, an investor will typically require both a tax credit guaranty and a guaranty of operating expenses for the project. With regard to the tax credit guaranty, the amount of capital contributions of the investor to the owner (and the master tenant) will be based upon the amount of tax credits expected to be generated by the project; and, to the extent that fewer credits are ultimately available than were expected, the investor will be entitled to receive a refund of some of its capital contributions. With regard

to the operating deficit guaranty, the investor will typically require the developer or an affiliate to agree to guaranty operating shortfalls for the five-year compliance period.

HRTCs will be recaptured if there is a "disposition" of the rehabilitated property within five years of the placed-in-service date.§ 50(a)(1). There is a disposition with the conveyance of the rehabilitated property, including foreclosure or the conveyance of all (or a portion) of the ownership interest in the entity that owns the rehabilitated property. Treas. Reg. § 1.47-6(a). Further, it should be noted that the sale or charitable contribution of a conservation easement or façade easement constitutes a disposition of the property for purposes of the recapture provisions. Rev. Rul. 89-90.

There is a "burn off" of liability each year with the vesting of 20% of the HRTCs each year. The amount of the credit recaptured is reduced by 20% for each full year that elapses after the property is placed in service—that is, the applicable recapture percentages for disposition in years 1 through 5, respectively, are: 100%, 80%, 60%, 40% and 20%.

Finally, both the developer and the tax credit investor will want to agree upon an "exit" strategy for the investor after the five-year compliance period. This exit mechanism may consist of a combination of put and call rights with regard to either the project or the investor's interest in the Partnership, which are designed to enable the project developer to buy out the investor at a price acceptable to both of them at a future date. The put may be at a price certain. However, if the put is not exercised by the investor, because of constraints of federal income tax laws, the "call" purchase price must be based on fair market value (at the time of the transfer), which may be affected by the existence of long-term master leases, unpaid fees and the reduction of the investor's profit share from 99% down to a smaller percentage. Typical documents will be attached as exhibits to your presentation illustrating the put/call arrangement.

How HRTCs Help Finance Projects

The HRTC program has a broad reach because access to the program is not limited by a state or federal ceilings on the amount of the credits. This is a real plus, considering the national limits on the amount and allocation of new markets tax credits ("NMTC") available and the state limits set on the amount and allocation of low-income housing tax credits ("LIHTC"). Participation in both the NMTC and LIHTC programs is very competitive, and very good projects may not achieve funding.

However with the HRTC program, the determining factor is the eligibility of the historic structure and not funding ceilings. If the building meets the criteria of the SHPO office and the NPS, the project will be eligible for HRTCs without a cap on the amount. For example, if a project involves $200 million in rehabilitation work that meets the NPS criteria, 20% of that amount or $40 million will be eligible for HRTCs; there is no cap imposed because of outside annual limits or the competitive process. HRTCs are available as a "matter of right" if the building itself and the rehabilitation work are otherwise eligible. For eligible buildings that are outside an historic district, the developer is able to pursue the process to have an historic district created, given that there are no statutory limits on the number of historic districts in a given city or town.[10]

As with other tax credit programs, the HRTC is a tool for the resourceful developer to reduce the cost of capital. A developer may choose to use HRTCs to offset its income tax burden, or the developer may transfer the HRTCs to an investor acquiring an ownership interest in the project in exchange for a capital investment. The HRTC investment structure creates additional opportunities for increasing a project's rate of return. An efficient market has developed for the "sale" of HRTCs, and investors contribute capital in the range of $.95 to $1.15 for each $1.00 of HRTCs obtained. This sale price is offset by the put exit fee required by some tax credit investors at the end of the five years, which may be as high as the return of 20% of the capital invested.

The HRTC program can be used to generate a source for mezzanine or bridge financing for a project. Typically, tax credit investors are reluctant to invest capital until the project is close to completion so as to reduce risk. Some developers have structured deals so that the tax credit investor commits to "buying" the HRTCs, and then this funding commitment can be used to obtain a bridge loan or increase the size of the construction loan, with the tax credit investment being used to pay down this loan at project completion. It remains very important that the closing for the tax credit investment be completed before the building is placed in service, which usually means closing before the certificate of occupancy is obtained.

There are some drawbacks to HRTC program:

- First, the significant oversight by the NPS of the historic restoration process often translates into increased construction costs. The developer is required to preserve the historically significant elements of the structure as determined by the NPS, and the elements selected may involve substantial additional expense. This is often the case, for example, with exterior windows that the NPS will require to be restored. There may also be undesirable restrictions on floor layout and design.
- Second, the five-year holding period presents a constraint that developers may find problematic. For HRTC projects that involve residential development, rental of the units will be required for the five-year holding period, and the developer will not realize the market and cash flow benefits from the sale of the residential units until the end of the five-year period. The developer may miss the peak market for the sale of the units because of this constraint.
- Finally, developers have to be prepared for significantly higher transaction costs for HRTC projects. The services of architects, accountants, appraisers and attorneys who specialize in HRTC projects will be required. While the serv-

ices of these specialists help avoid compliance problems, a project of sufficient scale is required to justify the higher transaction costs.

Developers may benefit from both the HRTC and NMTC programs on the same project without triggering the recapture provision. Taxpayers should also note that IRC provisions including the "at-risk" rules, passive activity limitations and alternative minimum tax may affect the ability to use the HRTC. Finally, a taxpayer may not be eligible for the HRTC program when the property is used by certain governmental and tax-exempt entities.

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[1] National Trust for Historic Preservation, Rehabilitation Tax Credit Guide, www.ntcicfunds.com/taxcreditguide/.

[2] Note that there is a special 60-month period for rehabilitation conducted in phases.

[3] To receive tax credits, certain percentages of the original walls and framework must be retained in the rehabilitation process. See § 47(c)(1)(A).

[4] Under some circumstances, the NPS recognizes state or local historic districts that are not listed in the National Register of Historic Places as qualifying as "registered historic districts."

[5] Rental housing does not qualify as commercial non-residential use for the 10% credit, but a hotel does qualify as commercial non-residential use.

[6] If the building is in a historic district included in the National Register, but not individually listed, the building may be eligible for the 10% HRTC only if the NPS determines that the building does not contribute to the district's historic nature and is not a certified historic structure.

[7] Auer, Michael J., *Preservation Tax Incentives for Historic Buildings,* publication of the U.S. Department of the Interior National Park Service, 2004.

[8] The recapture amount is 100% of the HRTC if the owner sells the property in the year the HRTC is taken and is reduced by 20% for each year thereafter during the five-year recapture period.

[9] Auer, Michael J., *Preservation Tax Incentives for Historic Buildings*.

[10] The developer will find that obtaining approval for an historic district may be a time-consuming process, and neighboring property owners may be supporters or opponents of the historic district. Sufficient lead-time will need to be built into the development schedule if a new historic district will be required.

Federal Appeals Court Holds That Supplemental Unemployment Compensation Benefits Are Not 'Wages' Subject to FICA Taxation, Creating Circuit Split

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Overview

In an important recent decision, *United States v. Quality Stores, Inc., et al.*, Case No. 01-1563, 2012 U.S. App. LEXIS 18820 (6th Cir. Sept. 7, 2012), the U.S. Court of Appeals for the Sixth Circuit held that supplemental unemployment compensation benefits ("SUB payments") paid by a bankrupt company to its former employees were not wages subject to taxation under the *Federal Insurance Contributions Act* ("FICA"). Accordingly, the employer and its former employees were entitled to refunds of amounts paid to the Internal Revenue Service ("IRS") on account of FICA taxes from severance payments that had been made after the employer filed for bankruptcy. The Sixth Circuit declined to follow a contrary 2008 decision on the issue of the Federal Circuit, *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008), the only other court of appeals decision to address the issue. The refund claim at issue in *Quality Stores* totals approximately $1 million (plus interest); it is estimated that similar pending refund claims total over $4 million.

A reduction in federal tax liability is obviously beneficial to both employer and employee taxpayers. The *Quality Stores* decision could be especially beneficial to lower wage employees for whom FICA taxes constitute a major portion of their federal tax liability. Elimination of FICA tax liability would also increase the disposable income available to employees already suffering reduced earning prospects as a result of being laid off.

From the employer standpoint, the reduced FICA tax liability would free up money for deployment elsewhere in the enterprise at a time when funds may be tight. Employers who made severance payments to involuntarily terminated employees during the last few years could be affected by the decision. Thousands of companies are believed to have filed protective refund requests totaling $4 billion or more. Taxpayers should be aware of both a three-year statute of limitations to file a refund claim and a two-year statute of limitations for bringing a lawsuit after the denial of a refund request. It appears that many taxpayers have filed refund requests within the statute of limitations period to ensure that such requests were timely filed. It is believed that the IRS has been inundated with refund claims and, therefore, may not have processed the claims and communicated with taxpayers about the status of such claims in an orderly fashion. As a result, some taxpayers may be unaware that their refund requests have been denied because they may not have received notice of the denial. In such a case, the taxpayer may be unaware that the two-year period is running. Where lawsuits have been filed, the government reportedly has moved to stay the action pending the outcome of the *Quality Stores* litigation.

Quality Stores not only created a conflict among the federal courts of appeal on the applicability of FICA taxes to SUB payments, but it also raised a number of other important issues, including the level of deference to be afforded to IRS revenue rulings; the continued validity of the Supreme Court's decision in *Rowan; Cos v. United States;* the impact of the so-called "decoupling amendment" (discussed below) on *Rowan;* and the Treasury's ability to change the treatment of SUB payments under FICA through Treasury regulations.

Background

Quality Stores, Inc. was the largest agriculture-specialty retailer in the country. In October 2001, Quality Stores and its affiliates filed Chapter 11 petitions, closed all of its stores and distribution centers, and terminated all of its employees. In addition, Quality Stores made severance payments to those employees whose employment was involuntarily terminated pursuant to severance plans that did not tie the payments to the receipt of state unemployment compensation, nor were the payments attributable to the provision of any particular services by the employees.

Because the severance payments constituted gross income to the employees for federal income tax purposes, under a special statutory provision, Quality Stores reported the payments as wages on W-2 forms and withheld federal income tax. Quality Stores also paid the employer's share of FICA tax and withheld each employee's share of FICA tax. The IRS contended that most SUB payments constitute wages subject to FICA tax, except for SUB payments that satisfy an eight-factor test established in certain IRS revenue rulings—including a requirement that the payments be tied to the receipt of state unemployment compensation benefits. Although Quality Stores collected and paid the FICA tax, it did not agree with the IRS

that the severance payments constituted wages for FICA purposes. Quality Stores took the position that the severance payments were not wages subject to FICA tax.

Therefore, in September 2002, Quality Stores timely filed with the IRS refund claims on behalf of itself and certain of the former employees seeking the refund of all of the amounts paid for FICA tax, totaling approximately $1 million. After the IRS failed to allow or deny the refund claim, Quality Stores commenced an adversary proceeding in the bankruptcy court to recover the refund in June 2005. The parties stipulated that, to the extent that the refund claim was allowed, Quality Stores would also be entitled to recover interest on the claim.

Lower Court Decisions

In February 2008, the bankruptcy court ruled in favor of Quality Stores, holding that the claimants were not liable for FICA taxes and were entitled to a refund. In its opinion, the bankruptcy court relied, in part, upon the decision of the Court of Federal Claims in *CSX Corp., Inc. v. United States*, 52 Fed. Cl. 208 (Fed. Cl. 2002). However, subsequent to the bankruptcy court's decision, the Federal Circuit issued its decision in *CSX*, reversing the Court of Federal Claims. Based upon *CSX*, the government moved for reconsideration of the bankruptcy court's decision. In August 2008, the bankruptcy court granted the government's motion for reconsideration but declined to follow the Federal Circuit's decision in *CSX* and ratified its prior decision. The government appealed the bankruptcy court's decision to the district court. In February 2010, the district court also declined to follow *CSX* and affirmed the bankruptcy court. In April 2010, the government appealed to the Sixth Circuit.

Origin of SUB Payments

In its opinion affirming the lower courts, the Sixth Circuit noted that the concept of SUB payments first appeared during the 1950s, evolving from the demand by organized labor for a guaranteed annual wage. SUB plans were developed to assure workers of employment security regardless of the number of hours actually worked, rather than to provide employees with additional compensation for work performed. When employers began adopting plans under collective bargaining agreements to fund trusts for the purpose of making SUB payments to employees in the event of unexpected job layoff or termination, it was critical that SUB payments not be characterized as "wages." If SUB payments constituted wages, then unemployed workers could not qualify for unemployment benefits under most states' laws, and the unavailability of unemployment benefits would largely defeat the purpose of SUB payments.

Definitions of 'Wages' and 'SUB Payments'

Congress imposed the FICA tax on employee wages to fund the Social Security and Medicare programs. The employer collects the employee's share by deducting the tax from wages as they are paid. The employer also pays a matching tax on the wages paid to the employee. Congress defined "wages" for FICA tax purposes (with certain exceptions) as "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash …." "Employment," for purposes of FICA, means "any service, of whatever nature, performed … by an employee for the person employing him." For purposes of income tax withholding, the Internal Revenue Code ("IRC") contains a nearly identical definition of "wages." In *Rowan Cos. v. United States*, 452 U.S. 247 (1981), the Supreme Court held that Congress intended the term "wages" to carry the same meaning for purposes of both FICA and federal income tax withholding.

The withholding tax provisions of the IRC contain the following definition of "SUB payments":

> amounts which are paid to an employee, pursuant to a plan to which the employer is a party, because of an employee's involuntary separation from employment (whether or not such separation is temporary), resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions, but only to the extent such benefits are includable in the employee's gross income. 26 U.S.C. §3402(o)(2)(A).

SUB Payments Are Not Wages

The parties had essentially stipulated that the severance payments made by Quality Stores satisfied this statutory definition. The Sixth Circuit noted that the IRC provides that a SUB payment "shall be treated *as if it were a payment of wages*" for purposes of the withholding tax provisions. The court found that the necessary implication arising from this phrase is that Congress did not consider SUB payments to be "wages," but allowed their treatment as wages to facilitate federal income tax withholding for taxpayers. The court further found that Congress's intention that SUB payments not constitute wages was supported by the legislative history. Thus, the Sixth Circuit concluded that, even though SUB payments are *treated as* wages for purposes of income tax withholding, all of such payments actually constitute non-wages. Moreover, because *Rowan* requires that the term "wages" be given the same meaning for purposes of FICA and income tax withholding, the court held that all SUB payments also constitute non-wages for purposes of FICA.

Sixth Circuit Rejects the Government's Other Arguments

The Sixth Circuit rejected the government's argument that Congress had legislatively superseded *Rowan* when it enacted the so-called "decoupling amendment" as part of the Social Security Amendments of 1983. That amendment, as written, author-

ized the Treasury Department to promulgate regulations to provide for different exclusions from "wages" under FICA than under the income tax withholding provisions. But, the court noted, the Secretary of the Treasury has never promulgated any regulations under the decoupling amendment.

The Sixth Circuit also rejected the government's argument that *Rowan* was eroded by the Supreme Court's decision in *Environmental Defense Fund v. Duke Energy Corp.*, 549 U.S. 561 (2007). On this point, the Sixth Circuit agreed with the reasoning of the Federal Circuit, which in *CSX* held that *Duke Energy* did not affect the continuing validity of *Rowan*. The Sixth Circuit also rejected the government's argument that the Supreme Court's decision in *Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704 (2011), undercut the validity of *Rowan*. In *Mayo Found.*, the Supreme Court concerned itself with *Rowan's* status as a case decided before *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), which accorded less deference to a Treasury regulation than is now required under *Chevron*. However, the court held that *Mayo Found.* added nothing of significance to the legal analysis in the present case.

Sixth Circuit Declines to Follow the Federal Circuit

The Sixth Circuit's holding that *Rowan* remains good law was consistent with the Federal Circuit's decision in *CSX*. However, the Sixth Circuit disagreed with one significant aspect of the Federal Circuit's decision in *CSX*. The Federal Circuit in *CSX* had confined the congressional definition of SUB pay in IRC § 3402(o) to federal income tax withholding only and did not rely on *Rowan* to conclude that the same statutory definition applies to FICA tax. The Sixth Circuit disagreed with this analysis, finding it to be inconsistent with other authority in the Federal Circuit. The Sixth Circuit relied on *Rowan* to reach the conclusion that if Congress decided that all SUB payments are non-wages for purposes of federal income tax withholding, then all SUB payments are also non-wages for purposes of FICA.

Revenue Rulings Did Not Control Decision

Finally, the Sixth Circuit found that the revenue rulings relied upon by the government did not alter its opinion. The court held that it would not accept the government's argument, which would have given greater significance to the IRS's revenue and private letter rulings than to congressional intent as expressed in the statutory language and legislative history.

Subsequent Developments

On October 18, 2012, the government filed a petition for rehearing *en banc* and on December 14, 2012, the appellees filed a response opposing the government's petition. If the petition is granted, the panel's decision will be reviewed by all of the judges in regular active service on the Sixth Circuit. If the petition is denied, many observers expect the government to ask the U.S. Supreme Court to review the decision and believe there is a good chance that the Court would accept the case for review. However, it is also possible that the government will not seek to have the Supreme Court review the case but rather will continue to litigate the issues in other circuits. In the meantime, *Quality Stores* will provide strong support to taxpayers seeking refunds of FICA taxes paid in connection with the many workforce reductions that have occurred during the Great Recession.

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Managing Social Media in the Workplace

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Introduction
In today's fast-paced digital society, we place a premium on "staying connected." Our social and professional lives are intertwined with such social media outlets as Facebook and Twitter. In its first quarterly earnings report to the Securities and Exchange Commission, Facebook reported that as of June 30, 2012, it had 955 million total users.[1] Twitter reported that it had 140 million users in March of 2012.[2] These social media outlets provide efficient avenues for communications and can become effective business tools for advertising and other promotional activities. While the benefits of social media are unquestionable, employers are now facing difficult policy decisions as they balance employee rights with business interests. Many of these policy decisions affect workforce morale and can lead to significant employer liability if handled improperly.

Recent case law is illustrative of employer pitfalls now arising in regulating employee social media access. Consider the following hypothetical: A chain store employer transfers an employee to another location. The employee is frustrated over the transfer and protests the move to her supervisor. After the supervisor fails to transfer the employee back to her previous position, the employee logs onto Facebook and describes her feelings toward her supervisor using several expletives and also criticizes the employer in the process. Question—Is the employer justified in terminating this employee for her Facebook comments? Answer—No, according to the National Labor Relations Board (NLRB).[3] According to the NLRB, the employer's policy against disparagement of the company through any media outlet was unlawful because it could reasonably be construed to restrict Section 7 activity.[4] The NLRB further found that the employee engaged in protected concerted activity because her Facebook status generated a discussion about working conditions amongst fellow employees.[5] Therefore, the employee's termination was considered unlawful.

Realizing the potential liability presented by operating without a social media policy, employers have responded by crafting policies to regulate their employees' social media behavior. However, many of these social media policies are overly broad and infringe upon employees' Section 7 rights under the National Labor Relations Act ("NLRA").[6] Balancing legitimate employer interests with employee rights is essential in the development of an effective and legal social media policy.

General Confidentiality and Privacy Issues
When considering employment policies, confidentiality and privacy interests are of general concern for employees and employers alike. Employees like to know that their personal information in the possession of the employer will remain confidential. This employee interest continues to evolve as federal laws such as Family Medical Leave Act and Americans with Disabilities Act further regulate employers' handling of employee personal information. Likewise, employers want to ensure that employees preserve the confidentiality of certain company information and that employees will not use company property in a manner that would subject confidential company information to public disclosure. These confidentiality and privacy interests have evolved over decades of employer/employee relations and continue to remain highly relevant today. For employers, technology has created further need to protect and restrict disclosure of proprietary electronic information, inasmuch as with one email transmission, a disgruntled employee can reveal to the world the employer's inner workings including client data, customer lists and financial information.

In preserving confidentiality of company records, employers may create policies to ensure that company property is used properly and not abused by employees. Employers often institute Internet site restrictions and routinely review employee emails to confirm that company property is being used for its intended purpose.[7] While employees often believe that they possess a reasonable expectation of privacy in their activities while on the employer's network,[8] this belief is often misplaced, as employees' privacy rights are generally limited only to those instances where the matter intruded upon is "intensely private."[9] Employers can reinforce their right to monitor employee communications on the employer's network by placing the employees on notice that their emails and Internet activities will be monitored.[10] With notice of an employer's policy of monitoring network activity, it is difficult for employees to claim that they have a reasonable expectation of privacy. Courts will typically balance a company's interest in preventing unprofessional conduct or illegal activity over its network against any privacy interest an employee can claim in those activities, and this analysis typically favors employers.[11]

Regulating social media presents similar challenges for employers. Social media can be misused by employees and, thus, subject employers to liability, create confidentiality issues and result in significant public embarrassment.[12] Other more specific employer concerns regarding employee use of social media may include: (1) the use of offensive language or posting of inappropriate materials; (2) the disparagement of the company and its directors, officers and employees; (3) the harassment of co-workers; (4) the transmission of computer viruses; (5) or the general lack of employee performance due to their use of social media outlets.[13] Properly crafted social media policies better protect employers against this type of misuse and may further help mitigate damages flowing therefrom.

Drafting an Effective and Legal Social Media Policy

When crafting a social media policy, employers must remain mindful of employee rights protected by the National Labor Relations Act ("NLRA"). The NLRA protects employees' rights to "engage in concerted activities for the purpose of collective bargaining or other mutual aid or protection" (referred to herein as "Section 7 rights").[14] For an activity to be "concerted activity," an employee must act "with or on the authority of other employees and not solely by and on behalf of the employee himself."[15] The NLRB is the administrative body charged with investigating and preventing any person or company from engaging in violations of the NLRA.[16] If an unfair labor practice is determined, the NLRB can issue cease and desist orders and take other action warranted under the circumstances.

Employers and lawyers alike frequently operate under the mistaken belief that the NLRA does not apply to non-union employers. However, the NLRA only excludes from its definition of "employer" state and federal government employers and any employer subject to the Railway Labor Act. Most other employers are prohibited from interfering with rights provided to employees under the NLRA.[17] Employers will violate Section 8(a)(1) of the NLRA when a work rule is enforced that "reasonably tends to chill employees in the exercise of their Section 7 rights."[18] If an employer's social media policy is overly broad in nature so that it encompasses certain Section 7 activities, it may violate the NLRA and an action by a disgruntled employee could be brought to the NLRB.

The NLRB, through its acting general counsel, has recently provided examples of acceptable and unacceptable social media policies in a series of memoranda.[19] These memoranda address such topics as materials employees are prohibited from posting online, overly broad policies that infringe upon employee rights, and general "do's and don'ts" for employers in regulating employee social media usage. These memoranda provide employers with an excellent resource to rely upon in the creation of social media policies and the administration of such policies in the employer/employee setting.

Specific Examples of Unlawful Social Media Policies

One of the common themes presented through the NLRB memoranda is the potential illegality of overly broad, vague or ambiguous social media policies that infringe upon employees' Section 7 rights. A social media policy that is vague or ambiguous in its application to Section 7 rights or provides no limitations or examples that would signal to employees that the policy does not restrict Section 7 rights is unlawful.[20] On the other hand, a social media policy that sets clear boundaries that restrict its scope by including examples of conduct that are clearly illegal or unprotected to the point where the policy could not be read to cover Section 7 rights is lawful.[21] In Memorandum OM 11-74, the acting general counsel of the NLRB described an employer's Internet/blogging policy that prohibited employees from engaging in "inappropriate discussions." This language was considered overly broad and could reasonably be construed to restrict Section 7 activity.[22] The policy did not attempt to explain the meaning of "inappropriate discussions" or limit its scope through specific examples to exclude Section 7 activity and was, therefore, considered unlawful in its application.[23]

Other specific examples offered by the NLRB of inappropriate social media policies include a policy that prohibited employees from using social media to engage in "unprofessional communication that could negatively impact the Employer's reputation or interfere with the Employer's mission or unprofessional / inappropriate communication regarding members of the Employer's community."[24] According to the NLRB, this type of restriction violates Section 8(a)(1) "because it would reasonably be construed to chill employees in the exercise of their Section 7 rights" and could also encompass protected statements about employment practices.[25] Further, according to the NLRB, such policy contains no limitations or examples that would indicate to an employee that Section 7 rights were excluded from the prohibition.[26]

Further, a policy requiring employees to seek approval from their employer to identify themselves as the employer's employees on a social media site and to state expressly that their comments are their personal opinions and do not necessarily reflect their employer's opinions likely violates the NLRA.[27] A provision of this type is considered overly broad and also damaging to the employee's Section 7 right to engage in concerted activity.[28] Further, requiring employees to explicitly state that their comments are their own and not those of their employer after each comment posted places an unreasonable burden upon employees who seek to exercise their Section 7 rights.[29] Another social media policy that required employees generally to "avoid identifying themselves as the [e]mployer's employees unless discussing terms and conditions of employment in an appropriate manner" was also found to be unlawful.[30] Aside from the overly broad nature of the term "appropriate" in this policy, the NLRB views this requirement as restricting protected activities such as criticizing terms and conditions of employment and the employer's labor policies.[31]

The NLRB has also found that policy provisions prohibiting the use of a company's name or service marks outside the course of business without prior approval of the company violate the NLRA.[32] The NLRB concluded that employees have a Section 7 right to use their employer's name or logo in conjunction with protected concerted activity, such as to communicate with fellow employees or the public about a labor dispute. The NLRB further concluded that because this provision could reasonably be construed to restrict employees' Section 7 rights, it violated the NLRA.[33]

Finally, a policy prohibiting employees from publishing any representation about their employer without prior approval by senior management was determined to be overbroad by the NLRB and in violation of the NLRA because it interfered with employees' Section 7 rights.

As the preceding examples demonstrate, it is imperative that employers carefully construct social media policies that provide specific limitations and examples that make it clear to employees that their individual Section 7 rights are protected; otherwise, these polices will be considered overbroad.

Specific Examples of Acceptable Social Media Policies
While employees have a wide range of rights and liberties in this area, employers do have a protectable interest in regulating social media. The NLRB has upheld as lawful social media policies that contain rules prohibiting employees from engaging in certain behaviors via social media. Such policies typically list prohibited actions such as breaching confidentiality, harassment or disparagement of other employees, or disparagement of the company. With the necessary specificity, such policies have been consistently upheld as lawful. Specific examples of acceptable social media policies include:

- A policy that "precluded employees from pressuring their coworkers to connect or communicate with them via social media."[34] This policy did not restrict Section 7 activities because it was "sufficiently specific in its prohibition against pressuring coworkers and clearly applied only to harassing conduct"[35];
- A policy that prohibited the use of social media to "post or display comments about coworkers or supervisors or the employer that are vulgar, obscene, threatening, intimidating, harassing, or a violation of the employer's workplace policies against discrimination, harassment, or hostility on account of age, race, religion, sex, ethnicity, nationality, disability, or other protected class, status, or characteristic." Once again, this policy was upheld as lawful as the policy clearly identified egregious misconduct and was not utilized to discipline Section 7 activities[36];
- A policy containing a rule prohibiting "verbal or other statements that are slanderous or detrimental to the company or any of the company's employees."[37] This rule was found on a list of 19 rules prohibiting such egregious conduct as sabotage and sexual or racial harassment.[38] The NLRB found that the rule could not reasonably be read to encompass Section 7 activity because "slanderous" and "detrimental" activities were egregious activities that did not involve concerted activity and could be lawfully prohibited. The NLRB also upheld a policy prohibiting conduct "that tends to bring discredit to, or reflects adversely … on the Company" and prohibiting "conducting oneself unprofessionally or unethically, with the potential of damaging the reputation of a department of the Company."[39] While the NLRB agreed that the policy was a bit overbroad and vague and would have preferred to see explicit Section 7 right exclusions, it found the policy to be lawful because the totality of the evidence led to a conclusion that the rule was not aimed at conduct related to Section 7 activities, but was related to crimes and other misconduct, such as giving proprietary information to competitors.

From a review of these "acceptable" social media policies it is apparent that the NLRB favors specificity over generalities. As such, significant interest should be placed on tailoring a policy specific to the needs of the underlying company as one size may not fit all as related to an enforceable policy.

Closing
Practitioners, prior to drafting a social media policy, should first consider the nature of the client's business and the protectable interests involved. Once they are determined, significant interest should be placed upon the specific employee activities subject of regulation. Using a cookie-cutter form policy found through a Google search may not address the specific needs of the client's business or comply with NLRB standards. There is no one size-fits-all social media policy; companies will need to craft their policies carefully to incorporate industry-specific concerns while maintaining necessary employee rights. In this digital age, social media will continue to thrive and employees will continue to connect with others and voice their opinions (and, oftentimes, their displeasure) with their working environments. Inevitably, litigation will further shape the landscape of employer/employee relations as related to social media usage and policies derived therefrom. Proper planning and careful assessment will further insulate employers from this imminent wave of litigation.

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[1] *See* http://www.sec.gov/Archives/edgar/data/1326801/000119312512325997/d371464d10q.htm (last visited Aug. 15, 2012).

[2] *See* http://blog.twitter.com/2012/03/twitter-turns-six.html (last visited Aug. 15, 2012).

[3] Memorandum OM 12-31 Report on Soc. Media Cases from the Assoc. Gen. Counsel of the Nat'l Labor Relations Bd. to All Reg'l Officers-in-Charge and Resident Officers (Jan. 24, 2012) (on file with NLRB) [hereinafter Memo 1]

[4] *Id*.

[5] *Id*.

[6] National Labor Relations Act, 29 U.S.C. §§ 151-169 (LexisNexis 2012).

[7] *See* John Soma et al., *Bit-Wise but Privacy Foolish: Smarter E-Messaging Technologies Call for a Return to Core Privacy Principles*, 20 Alb. L.J. Sci. & Tech. 487, 507-510 (2010); Christopher Pearson Fazekas, *1984 Is Still Fiction: Electronic Monitoring in the Workplace and U.S. Privacy Law*, 2004 Duke L. & Tech Rev. 15 (2004).

[8] Fazekas, *supra* note 9, at 15.

[9] *Id*.

[10] *Id*.

[11] *Id*.; *see also Smyth v. Pillsbury Co.*, 914 F. Supp. 97, 100-101 (E.D. Pa. 1996).

[12] See *Soma et al., supra* note 9 at 507-510.

[13] *Id*. at 515-516.

[14] 29 U.S.C. § 157 (2012).

[15] *Meyers Industries, Inc. v. NLRB*, 268 NLRB 493, 497 (1984) *aff'd sub nom*. Prill v. NLRB, 835 F.2d 1481 (1987).

[16] 29 U.S.C. § 160 (2012).

[17] 29 U.S.C. § 157 (2012); 29 U.S.C. § 158(a)(1).

[18] *Lafayette Park Hotel v. NLRB,* 326 NLRB 824, 825 (1998).

[19] *See* Memo 1, *supra* note 1; Memorandum OM 11-74 Report on Soc. Media Cases from the Assoc. Gen. Counsel of the Nat'l Labor Relations Bd. to All Reg'l Officers-in-Charge and Resident Officers (Aug. 18, 2011) (on file with NLRB) [hereinafter Memo 2]; Memorandum OM 12-59 Report on Soc. Media Cases from the Assoc. Gen. Counsel of the Nat'l Labor Relations Bd. to All Reg'l Officers-in-Charge and Resident Officers (May, 30 2012) (on file with NLRB) [hereinafter Memo 3].

[20] *University Medical Center v. National Labor Relations Board*, 335 N.L.R.B. 1318, 1320-1322 (2001), *abrogated in part by Caesar's Entm't v. NLRB*, No. 28-CA-60841, 2012 NLRB Lexis 134 (NLRB Mar. 20, 2012).

[21] *Tradesman International v. NLRB,* 338 NLRB 460, 460-462 (2002).

[22] Memo 2, *supra* note 19.

[23] *Id*.

[24] *Id*.

[25] *Id*.

[26] *Id*.

[27] Memo 1, *supra* note 1.

[28] *Id*.

[29] *Id*.

[30] *Id*.

[31] *Id*.

[32] Memo 1, *supra* note 1.

[33] *Id*.

[34] Memo 2, *supra* note 18.

[35] *Id*.

[36] *Id*.

[37] *Tradesman International v. NLRB*, 338 NLRB 460, 462 (2002).

[38] *Id*.

[39] *Ark Las Vegas Restaurant Corporation v. AFL-CIO*, 335 NLRB 1284, 1291(2001).

A Case for Clarity

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The interpretation of use clauses in commercial retail leases is common fodder in our courts today. An opinion out of the District Court of New Jersey raises the common question for transactional lawyers: How we do draft a use provision, particularly as it relates to an exclusive use that is clear and impenetrable?

The case of *2000 Clements Bridge, LLC v. Officemax North America, Inc.,* Civil Action No. 11-57 (JEI/KMW) (D.N.Y. Aug. 21, 2012), unfortunately does not offer a black-and-white answer, but it does provide yet another lesson for drafters of such clauses. Office Max entered into a lease for space within a shopping center in 2007. The exclusive use clause in the Office Max lease provided as follows:

> During the initial term of this lease or during any renewal period hereunder, and for so long as Tenant is operating an office supply superstore from the Demised Premises, Landlord covenants and agrees that it shall not enter into a lease or sale of any portion of the Shopping Center (excluding the Demised Premises) for the following:
>
> (a) For the purpose of, or which is permitted to be, the sale of office, home office, school or business products, computer and computer products, office, home office, school or business supplies or equipment; office furniture; or electronics (including by way of example those businesses operated by Office Depot, Staples, Office Shop Warehouse, Mardel Christian Office and Education Supply Store, Mail Boxes etc., and Workplace); or for use as a business support center, copy center or "Kinko" type of operation (all of which are hereinafter referred to as the "Prohibited Uses"), except to the extent permitted by subparagraph (b) immediately below … or
>
> (b) For any purpose which would permit more than (i) one thousand (1,000) square feet of space to be used for any Prohibited Uses…."

A remedy for a violation by landlord was the right of Office Max to terminate the lease if the violation remained uncured for a period of 60 days following written notice to the landlord.

Another relevant lease provision was a co-tenancy clause, which provided that if Circuit City (among others) ceased operations for a period in excess of six months, Office Max's rent would abate until the landlord cured the co-tenancy problem by finding a replacement tenant. "Replacement Tenant" was defined as "a new tenant to replace the vacating Major Tenant." The lease further provided for a termination right if a Replacement Tenant was not in place within 18 months.

In March 2009, Circuit City ceased operations, and the space remained dark until May 2010 when the landlord leased the space to hhgregg. The "Use" section of hhgregg's lease was as follows:

> <u>Use</u>. Except with respect to the Exclusive Uses and Restrictions, which are listed in Exhibit "D" attached hereto, and to the extent not prohibited by the Permitted Encumbrances listed in Exhibit "F" attached hereto, Tenant may use the Premises for any lawful retail purpose including, but not limited to the display and retail sale of electronics, appliances, audio and video equipment, computers and bedding as typically sold in stores operated by Tenant, and for the storage of merchandise or service related purposes ancillary to the sale of its goods."

Exhibit "D" of the hhgregg lease included, verbatim, the prohibited use language from the Office Max lease.

Office Max exercised its right to pay percentage rent only and also put the landlord on notice that the hhgregg tenancy violated Office Max's exclusive use for the sale of electronics. The landlord disagreed, and, following the required period of time, Office Max sent notice of its termination of the lease. The question before the court on cross-motions for summary judgment was the propriety of Office Max's termination of the lease under either the exclusive use provision or the co-tenancy provision.

The court found that Office Max had no right to terminate its lease under either provision and granted the landlord's motion for summary judgment on its breach of contract claim against Office Max. The court focused its attention on reconciling the fact that the prohibited uses provision in the hhgregg lease purportedly prohibited the sale of computers and electronics while the use provision expressly permitted such retail activity. The court questioned the logic behind an electronics retail store entering into a lease that prohibits the sale of electronics and indicated that "the Court cannot fathom" that this would be the intent of hhgregg. Rather than chalking this up to poor drafting and negotiating, the court concluded that the list of prohibited uses in the Office Max lease as well as the list of example tenants must be read together such that the sale of the prohibited products is only prohibited when sold through a prohibited office superstore. Since hhgregg is not an office super-

store and was not listed as an example tenant, it was not bound by the Office Max lease. The court determined that common sense and rules of construction require this conclusion since, to decide otherwise, would render the list of example tenants meaningless. The court also rejected a termination of the lease under the co-tenancy provision. Since nothing in the Office Max lease required a Replacement Tenant to abide by the prohibited uses, any argument to that effect was without merit.

The Take-Away

The take-away from this case is simply a reminder that attorneys must be as clear as possible in drafting the parties' intent. Perhaps in this case the use of example tenants was unnecessary or should have been used without the list of prohibited products. If the court's interpretation was the true intent of the parties, the lease language should have (and could have) definitively said so. Failing such clarity, attorneys run the risk of a court interpreting our language through its rules of construction, which may ultimately fly in the face of good business sense.

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Co-tenancy or Operating Covenant Remedies: Penalty or Bargained-for Remedy?

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In shopping center leases, landlords and tenants protect themselves with monetary remedies for when the tenant goes dark or fails to operate, or when the landlord cannot meet the co-tenancy requirements set forth in the lease. Recently, there has been a surge in landlords and tenants that are challenging the monetary remedies in the leases for co-tenancy or operating covenant failures as unenforceable penalties. Often, the challenged leases are antiquated and negotiated in a vacuum long before the parties make use of the remedies or the implication they might have on the shopping center. Typically, the challenged remedies, such as 50 percent rent abatement for a co-tenancy failure, are triggered regardless of whether the tenant suffered any economic loss at the shopping center. In fact, sometimes the tenant actually increases its sales and profit margin.

This article discusses the recent surge of cases, as recent as 2012, where the landlord or tenant challenged the lease remedy as an unenforceable penalty rather than a liquidated damages provision. The reality is that the landlords and tenants must carefully negotiate their leases because the courts will most likely hold the parties to the language set forth in their leases.

The Typical Remedies

In many shopping center leases, the parties negotiate options of remedies in the event of the failure of either the landlord or tenant to fulfill its co-tenancy or operating covenants. Typically, when the landlord has not fulfilled a covenant, the tenant may have a right to rent abatement, which means that the tenant pays a lower rent percentage for as long as the landlord does not cure the co-tenancy violation. Usually, the amount ranges from 25 percent or 50 percent reduced from the monthly rent or a certain percentage of gross sales. If the co-tenancy remains uncured over a certain period of time, usually 9 to 12 months, then the tenant may also terminate the lease for a co-tenancy violation. The landlord may reserve a right to find replacement tenants to fill co-tenancy vacancies.

On the other hand, if the tenant breaches an operating covenant, the landlord may require the tenant to pay daily or monthly fixed damages, which may be the agreed-upon monthly rent or the difference between the lease rent and the lost opportunity rent that the landlord would collect from a new tenant. If the landlord chooses to terminate the lease, the landlord may collect accelerated rent damages, holding the tenant immediately liable for the difference between the rent for the rest of the lease term minus the fair rental value of the premises. Alternatively, the landlord may pursue injunctive relief to keep the tenant open for the remainder of the lease in compliance with a continuous operating agreement.

When these remedies are sought to be enforced, the landlord for a co-tenancy violation and the tenant for an operating covenant breach may challenge the remedy as an unenforceable liquidated damages provision. If the court analyzes a remedy as a liquidated damages provision, it typically decides: (1) if the parties agreed upon a sum to be paid as liquidated damages; (2) if the damages at the time of contract were uncertain or incapable to be ascertained; and (3) if the sum is reasonable and not grossly excessive of the harm suffered.

The cases indicate that courts tend to shy away from this analysis; even when considering these factors, courts are likely to enforce the remedy provision as written.

Enforceability of Tenant Remedies for Co-tenancy Failures

Two federal court opinions in 2012 illustrate challenges that the landlord made for rent remedies for co-tenancy failures. In both cases, the courts enforced the rent remedies negotiated in the leases. What is interesting in these decisions is how the courts treated the remedial provisions in the leases in considering whether the remedy had to bear any relationship to anticipated or actual damages by the tenant.

In *Old Navy, LLC v. Center Developments Oreg., LLC,* the United States District Court for the District Court of Oregon upheld the tenant's rent remedy and found that such a provision would not be considered a liquidated damages provision but rather a tiered rent structure that would be triggered if a co-tenancy was not satisfied.[1] Therefore, the district court did not analyze the facts to determine if the rent remedy was an unenforceable penalty.

In *Hickory Grove, LLC v. Rack Room Shoes, Inc.,* the United States District Court for the Eastern District of Tennessee found that the lease entitled the tenant to pay only 4 percent of gross sales or the guaranteed minimum rent defined in the lease for a co-tenancy failure. The court would not consider if the remedy bore any relationship to the tenant's actual damages because the provision was unambiguous and did not require such an inquiry.[2]

Careful examination of these two cases demonstrates the difficulty in challenging co-tenancy remedies as unenforceable penalties.

The Old Navy Case

Old Navy claimed that when a "key store" closed, the "co-tenancy failure" was triggered, entitling Old Navy to pay a lower rent of "two percent (2%) of all gross sales made in the premises for each month" or "the amount of minimum rent then applicable."[3] Old Navy also claimed that the landlord failed to both inform it that the "key store" had closed and seek Old Navy's approval of New Seasons as a substitute tenant in breach of the lease. Additionally, Old Navy claimed that New Seasons was not an adequate substitute under the lease. Old Navy sought $572,480.72, interest and attorney fees.[4]

The court rejected the landlord's argument that the remedy should be considered an unenforceable liquidated damages provision.[5] On examining the co-tenancy requirements, the court found that "the provision does not impose any requirements on [the Landlord]; rather, it identified the condition necessary for [the Landlord] to require Old Navy to operate in the Mall."[6] The court treated the co-tenancy failure as follows:

> If the conditions for operating the Old Navy Store at the Mall are not met, Old Navy may choose to close its store and continue paying rent or it may choose to pay Alternate Rent—thus, invoking a tiered rent structure. In other words, [the Alternative Rent Remedy] does not provide for damages if [the Landlord] fails to keep certain tenants at the Mall.[7]

The district court, therefore, did not consider any evidence or argument that the remedy bore relationship to Old Navy's anticipated or actual damages.

The Hickory Case

Similarly, in *Hickory,* the district court did not consider whether the remedy for a co-tenancy failure bore any relationship to actual damages suffered by the tenant.

The shopping center lost the "key tenant," Goody's Family Store, and the landlord replaced the co-tenant with Goodwill Industries. Although the landlord sought to modify the lease with the tenant, Rack Room, for fixed rent, Rack Room ultimately decided to stay at the shopping center based on a reduced percentage of sales for the co-tenancy failure of a sum equal to 4 percent of gross sales.[8] The district court found that the parties did not modify the lease and that Goodwill was not a proper replacement tenant.[9] The landlord, therefore, argued that the co-tenancy provision was punitive in nature and bore no relationship to actual damages suffered by Rack Room. The landlord even offered evidence that Rack Room experienced an increase in sales with the Goodwill replacement. The court did not consider the evidence because: (1) the unambiguous language of the lease did not require the tenant to show decreased sales in order to invoke the co-tenancy provision, and (2) the landlord did not show any evidence of fraud or undue mistake nor that the provision was unconscionable.[10]

These two cases continue the long-honored tradition of enforcing the lease as written. Courts will likely not consider the financial impact to the tenant seeking rent relief under the lease or the financial impact on the shopping center.

Enforceability of Landlord Remedies for Tenant Going Dark or Failing to Operate

The same holds true when the landlord seeks damages from the tenant for failing to operate at the shopping center.[11]

In a recent California case, *El Centro Mall, LLC v. Payless Shoe Source, Inc.*, the shopping center owner sought to enforce the liquidated damages provision in the lease against Payless for going dark before the end of the lease term.[12] The lease contained a continuous operation clause, which allowed the owner to charge a daily rate of $0.10 per sq. ft. of the premises in addition to minimum annual rent, percentage rent and additional rent. This allowed the owner to charge an extra $98,000 in damages.[13] Payless challenged the liquidated damages provision as an unenforceable penalty that was "arbitrarily applied to the tenants at [the] shopping center and therefore could not be a reasonable estimate of potential damages at the time the lease was signed."[14]

The court noted that liquidated damages clauses are presumptively enforceable under California law. Therefore, the challenging party has the burden of offering conclusive evidence that the provision was unreasonable at the time of contract.[15] The court found that if the provision was used only as a basis to estimate percentage rental damages, it would be deemed an unenforceable penalty because percentage rent is readily calculated in the lease. The court, however, agreed with the owner that the liquidated damages provision also included damages for loss of synergy, goodwill and patronage, which are all difficult to estimate.[16] Although Payless produced evidence that the other tenants at the shopping center did not have to pay such liquidated damages, the court found that such evidence only raised an inference that the provision was arbitrary, and that there was no conclusive evidence regarding the circumstances of the other leases. Additionally, Payless did not show that the charged amount ($0.10 per sq. ft.) did not represent a reasonable estimate of actual damages that the owner would suffer if Payless breached the lease.[17]

Recommendations for Best Leasing Practices

Convincing a court to overturn a negotiated lease remedy for co-tenancy or operating breaches will likely continue to prove challenging. It appears that even if the landlord or tenant could convince the court to analyze whether the remedy should be considered a liquidated damage provision, there must be concrete evidence that the set amount was not a reasonable effort to estimate the fair compensation for the sustained loss; rather an arbitrary amount bearing no relationship to actual damages and/or that the damages could have been ascertained at the time of contracting.

Rather than rely on the courts to interpret these provisions and their enforceability, the cases discussed above demonstrate that landlords and tenants should consider further protections against what they may deem to be unrealistic damages.

For example, if a landlord wants to link the co-tenancy failure to the real effect on the tenant, the lease should build into the remedy provision that the tenant actually lose sales, which should be measured during the same time period to eliminate the variable of seasonal changes.[18] With respect to operating covenants, both landlords and tenants can protect themselves by agreeing to a grace period before either of them can terminate the lease and trigger damages. This grace period would allow a certain amount of time either for the tenant to reopen the store or for the landlord to find a replacement tenant and minimize or eliminate what may be perceived as penalties.

Rather than having the courts make determinations on these matters, shopping center disputes are better resolved when carefully negotiated by the landlord and tenant, who are better equipped to ensure that the shopping center operates to their mutual benefit.

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[1] *Old Navy, LLC v. Center Developments Oreg., LLC,* No. 3:11-472-KL, 2012 WL 2192284, *1, *10-*11 (June 13, 2012).

[2] *Hickory Grove, LLC, Rack Room Shoes, Inc.,* No. 1:10-CV-290, 2012 WL 1836330, *2, *11 (E.D. Tenn. May 21, 2002).

[3] 2012 WL 2192284, at *1-*2. Alternatively, Old Navy had the right to close its doors, but continue paying rent until it decided to reopen, and had the right to terminate the lease if the "Operating Requirements" were not met for more than nine months. *Id.* at *2.

[4] *Id.* at *1.

[5] Under Oregon law, the court undertakes a two-step inquiry in evaluating whether a provision awards unenforceable liquidated damages: (1) the court determines whether the disputed clause actually is a liquidated damage clause, and (2) the court determines if it is an unlawful penalty by considering factors set forth by statute. The factors in OR5727180(1) are as follows:

> Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.

Id. at *10.

[6] *Id.*

[7] *Id.* at *11.

[8] 2012 WL 1836330, at *2, *7.

[9] *Id.* at *11.

[10] *Id.*

[11] *See also Landover Mall, LP v. Kinney Shoe Corp.,* 944 F. Supp. 443 (D. Md. 1996) where the district court enforced a liquidated damages provision despite the presumption to construe the clause as a penalty. Although the tenant argued the clause operated as a penalty because the landlord's actual damages did not rise to the level of the liquidated damages amount, the court found that the actual damages would have been impossible to predict because the tenant's closure could affect the mall's vacancy rate, tenant mix, customer draw, profitability or the landlord's ability to lease the space again. *Id.* at 444. But, in New York, see *Pyramid Ctrs. & Co. v. Kinney Shoe Corp., 244 A.D. 2d 625 (N.Y. App. Div. 1997)* and *Irving Tire Co. v. Stage II Apparel Corp., 230 A.D. 2d 772 (N.Y. App. Div. 1996)*. (In both cases, New York courts held that the provisions were unenforceable penalties because the stipulated sums were plainly disproportionate to the actual harm suffered).

[12] *El Centro Mall, LLC v. Payless Shoe Source, Inc.,* 174 Cal. App. 4th 58 (2009).

[13] *Id.* at 61-62

[14] *Id.* at 60.

[15] *Id.* at 63.

[16] *Id.* at 64.

[17] *Id.* at 65.

[18] In addition to tying the co-tenancy to lost sales, landlords should consider that (1) the tenant is open and operating and therefore entitled to rent abatement, (2) the landlord should be able to replace the lost tenant with a suitable type of replacement, (3) the tenant should resume paying full rent if the tenant exercises a renewal option and (4) the tenant should at some point have to elect to either terminate the lease or pay full rent regardless.

Cases

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LABOR RELATIONS/PUBLIC ACCESS
The California Supreme Court holds that picketing activities on a privately owned walkway outside a customer entrance to a grocery store are not protected by the California State Constitution—but are protected by California statutes: *Grocery Co. v. United Food and Commercial Workers Union Local 8*, 55 Cal.4th 1083, 290 P.3d 1116, 150 Cal.Rptr.3d 501 (Cal. 2012).

Ralphs Grocery Company ("Ralphs") owns and operates a grocery store located in a retail development in Sacramento. The grocery store has only one entrance, which is accessed using a paved 15-foot-wide walkway separated from the parking lot by a driving lane. Shortly after the store opened, the United Food and Commercial Workers Union Local 8 ("Union") began picketing outside this entrance. For eight hours per day and five days per week, between four and eight Union representatives walked back and forth on the entrance walkway carrying signs, speaking to customers and handing out flyers. The Union representatives did not impede customer access to the store.

Approximately six months after the Union started picketing, Ralphs notified the Union that the Union was in violation of Ralphs' store regulations regarding speech activities. Specifically, Ralphs prohibited speech activities within 20 feet of a store entrance, speech activities during certain hours and for a week before certain holidays, physical contact with any person, distribution of literature, and display of any sign larger than 2 ft. by 3 ft. Ralphs also asked the local police department to remove the picketers, but the police department refused to act without a court order.

Ralphs filed a complaint in Sacramento County Superior Court seeking a temporary restraining order, a preliminary injunction and a permanent injunction barring the Union's representatives from using the store for speech activities unless they complied with Ralphs' store regulations. Ralphs argued that California Constitution's liberty of speech clause did not protect picketing in front of a store entrance. It also argued that California's *Moscone Act*, Cal. Code Civ. Proc. § 527.3(b) (which protects peaceful picketing by workers engaged in labor disputes) and § 1138.1 of the California Labor Code (which prohibits a court from issuing an injunction during a labor dispute except under extreme circumstances) violated the federal Constitution by providing more protection to labor-related speech than to speech on other issues. The trial court concluded that the *Moscone Act* was unconstitutional but still denied Ralphs' requests for a preliminary injunction. It determined that § 1138.1 precluded it from issuing an injunction and that Ralphs failed to establish that its regulations were reasonable time, place and manner restrictions.

The court of appeal reversed and remanded for issuance of a preliminary injunction. It held that both the *Moscone Act* and § 1138.1 violated the federal Constitution because they provided greater protection to labor-related speech than to speech regarding other issues. Accordingly, the court of appeal held that the Union's activities were not protected because the area around the store entrance did not constitute a public forum under the state constitution's liberty of speech provision.

The California Supreme Court affirmed in part and reversed in part. It agreed with the court of appeal that the Union's activities were not constitutionally protected. It declined, however, to rule that either the *Moscone Act* or § 1138.1 were unconstitutional and found that those statutes protected the Union's activities. Accordingly, even though the Union's activities lacked constitutional protection, the trial court properly declined to issue a preliminary injunction.

First, the court held that speech in a shopping center is constitutionally protected only if the area where the speech occurs is "designed and furnished in a way that induces shoppers to congregate for purposes of entertainment, relaxation, or conversation." This conclusion interpreted *Robins v. Pruneyard Shopping Center,* in which the Court held that shopping centers, even if privately owned, are public forums for the purposes of the California Constitution's liberty of speech clause. The *Ralphs* court determined that *Pruneyard* was not intended to apply equally to all areas in a shopping center. Instead, its protections applied only to areas where shoppers are encouraged by seating and other amenities to "to stop and linger, to leisurely congregate for the purposes of relaxation and conversation," and not to areas such as customer entrances or exits that serve primarily commercial functions. Accordingly, speech in the commercial areas of a shopping center, including areas used "merely to walk to or from a parking area, or to walk from one store to another, or to view a store's merchandise and advertising displays," is not protected by the California constitution and generally can be regulated by property owners.

Even so, the court held that Ralphs was not entitled to an injunction. The court reversed the court of appeal's holding that the *Moscone Act* and § 1138.1 violated the federal Constitution, noting that the U. S. Supreme Court has repeatedly rejected challenges to state and federal laws providing greater protections to labor-related speech than speech on other issues. Because both statutes prohibit the issuance of an injunction against "peaceful union picketing on a private sidewalk outside a targeted retail store during a labor dispute," the trial court properly declined to enjoin the Union's activities. The court remanded for further proceedings consistent with its opinion.

Chief Justice Cantil-Sakauye and Justice Liu issued separate concurring opinions. The chief justice opined that "speech or conduct directed toward interference with the owner's business by means other than persuasion of patrons to labor's position" was not protected by the *Moscone Act*, and that the *Moscone Act* did not affect property owners' rights to protect themselves by adopting and enforcing rules and policies regarding speech activities. Justice Liu believed that the *Moscone Act* and § 1138.1 were economic regulations that regulated judicial practices rather than speech regulations that favored labor-related speech over other speech activities.

Justice Chin issued a concurring and dissenting opinion, agreeing that the walkway was not a public forum, but disagreeing that labor-related speech could receive greater protection than other speech. Justice Chin warned that the court placed California "on a collision course with the federal courts" and invited Ralphs to seek review in the U. S. Supreme Court. At the time of writing, Ralphs had not filed a petition for *certiorari* in the U.S. Supreme Court.

The practical impact of the decision on retailers in California is somewhat unclear. On the one hand, the court recognized that retailers may adopt and enforce regulations regarding the exercise of speech outside of areas that constitute public forums. This recognition may allow retailers and property owners to seek help from law enforcement when their regulations are violated by expressive conduct, including labor-related speech activities. On the other hand, the court's holding prevents retailers from addressing violations of speech regulations through the court system if the offending speech is labor-related. If law enforcement refuses to respond without a court order, as did the police department in *Ralphs*, retailers may be left without redress.

LANDLORD-TENANT

A repair clause in a lease obligating the tenant to repair the roof did not require the tenant to replace the roof. *Whyzmuzis v. Plaza Shoe Store, Inc.*, 375 S.W. 928 (Mo. Ct. App. Sept. 17, 2012).

Plaza Shoe Store ("tenant") leased space in a shopping center owned by the Whymuszises ("landlord"). The tenant had been located in the shopping center for over 40 years and had entered multiple leases with the landlord, who had owned the shopping center since 1991. In 2004, the tenant executed a new five-year lease with the landlord. This lease included a repair and maintenance provision, obligating the tenant to make "all repairs required, including the roof, exterior walls, structural foundations and all other items." The lease reiterated: "This is a triple net lease: [Tenant] is responsible for all repairs and maintenance."

The tenant's roof had leaked rainwater since before the tenant entered the 2004 lease, but the leaks worsened after an ice storm in 2007. The tenant had unsuccessfully attempted to repair the roof; then, in February and March 2007, the tenant asked the landlord to replace it. The landlord told the tenant that roof repair was the tenant's responsibility under the lease, citing the repair and maintenance provision, and threatened the tenant with eviction unless the leaks were fixed.

In August 2007, the tenant notified the landlord that the roof could not be repaired and that the leaks had worsened to the point that the tenant could no longer conduct business in the leased premises. Two months later, after the landlord secured a new renter, the tenant vacated the premises in good condition, except for the roof.

The landlord sued the tenant, alleging that the tenant breached the lease by failing to repair the premises or pay rent for the full term. The trial court entered judgment against the landlord, finding that the tenant had not breached the lease. To the contrary, the tenant had discharged its obligations by making substantial effort to repair and maintain the roof, which was not repairable because it had exceeded its useful life. The landlord's failure to replace the roof constituted a constructive eviction of the tenant because leaking water posed a health and safety risk to the tenant's customers.

On appeal, the landlord argued that the tenant had not been constructively evicted because the tenant was required to replace the roof under the repair and maintenance clause. The Missouri Court of Appeals disagreed. Under Missouri law, specific lease language is required to shift the burden of making substantial structural repairs from a landlord to a tenant. Additionally, a repair clause should generally not be construed to require a tenant to surrender leased property in better structural condition than it was received. Because the repair and maintenance clause did not specify that the tenant was required to replace the roof, and because the tenant surrendered the property in otherwise good condition, the court of appeals held that the landlord was responsible for paying for the roof replacement.

The court of appeals separately applied a six-factor test adopted from a similar California Supreme Court case, *Hadian v. Schwartz*, 8 Cal.4th 836, 35 Cal. Rptr. 2d 589, 884 P.2d 46 (1994). In that case, the tenant and the landlord disputed whether the repair and maintenance clause in the tenant's lease required it to implement expensive earthquake-proofing required by the City of Los Angeles. The California Supreme Court considered six factors: (1) comparison of the cost of the curative action to the rent reserved; (2) the length of the lease term; (3) the relationship of the benefit to the lessee versus the lessor; (4) whether or not the curative action was structural; (5) interference with the lessee's use of the premises during the curative action; and (6) the likelihood that the parties contemplated the curative action. The California Court of Appeals found that the balance of these factors also favored the tenant: "In light of the short lease term, high reroofing cost relative to rent, and potentially short benefit to Tenant, we cannot find Tenant responsible for reroofing." The court of appeals therefore determined that the tenant was constructively evicted.

The Missouri Court of Appeals also rejected the landlord's argument that any constructive eviction was waived because the tenant knew that the roof leaked when it signed its lease in 2004. Constructive eviction can be waived if a tenant fails to abandon the premises within a reasonable time. The tenant did not waive constructive eviction because the roof leaks did not

interfere with the use of the premises until after they worsened in the 2007 ice storm. The court of appeals affirmed the trial court's judgment.

PREMISES LIABILITY

The New Jersey Superior Court, Appellate Department, imposes personal injury liability on a building owner in a multi-unit commercial condominium for off-site condition in an area that a condominium association was contractually obligated to maintain. *Nielsen v. Wal-Mart Store No. 2171*, --- A.3d ----, 2013 WL 132467 (N.J. Super. A.D. Jan. 11, 2013).

The plaintiff, William Nielsen ("Nielsen"), was injured in a slip-and-fall outside Walmart at a shopping center developed and owned by Nassau Shopping Center Condominium Association ("Association"). Nielsen was employed by an extermination company retained by Walmart. At the time of his fall, Nielsen was setting rodent traps in the building owned by Walmart. Although the traps were located inside the building, Walmart directed Nielsen to access the areas where the traps were placed by walking around the building's exterior. While walking from one entrance to another, Nielsen slipped on loose sand and gravel that had accumulated between a grassy area and an asphalted area.

Although the area where Nielsen fell was owned and maintained by the Association, Nielsen sued Walmart and did not sue the Association until much later. (Nielsen's employer, presumably, was immune under New Jersey's workers' compensation statute.) Nielsen's claim against the Association was dismissed as barred by the statute of limitations. Walmart also moved for summary judgment, arguing that it could not be held liable for injuries caused by conditions outside its unit in an area where it had no repair or maintenance obligations; but its motion was denied. Walmart later sought leave to file a third-party complaint against the Association. The motion was denied because (1) Walmart had not objected to the Association's motion for summary judgment and (2) the trial was scheduled for only a few weeks later.

At trial, the jury found Walmart negligent and awarded damages to Nielsen and his wife. Walmart unsuccessfully moved for judgment notwithstanding the verdict or new trial, and then appealed. The primary issue before the court was whether Walmart was properly held liable for an injury resulting from a condition off its premises.

The court noted that the common law traditionally absolved landowners of liability for injuries occurring off their property, but that New Jersey courts had moved away from that bright-line approach to a multi-factor analysis to determine whether a duty should be imposed. Generally, this analysis places greater weight on public policies favoring compensation for pedestrians and prevention of future harm, with much less weight given to contractual arrangements and property boundaries.

Although the court recognized that Walmart's ownership or control of the area when Nielsen fell was one consideration, it gave that factor little weight in its analysis. It noted that New Jersey landowners have a duty to maintain public sidewalks abutting their property in reasonably good condition and protect invitees and passersby from other hazardous conditions, and are liable for their negligent failure to do so. The court also placed little weight on whether Walmart had contractually agreed to maintain or repair the area where Nielsen fell. The court held that between the Association and Walmart, the Association was obligated to maintain and repair the area, but that arrangement does not limit Walmart's liability to invitees, like Nielsen, who are injured during their foreseeable use of common areas.

The court placed greater weight on the fact that declining to impose liability on Walmart would cause additional injuries by encouraging Walmart and similarly situated landowners to ignore hazardous conditions in common areas. Additionally, the court emphasized that Walmart was receiving benefit from Nielsen's presence on the property and that Walmart required Nielsen to perform his job by walking around the exterior of the store. By directing the manner in which Nielsen performed his work, Walmart implicitly assumed the risk arising from his activity and should have managed that risk by addressing hazards in the common area. The court also noted that a landowner in Walmart's position could typically recover from the owner of the common areas through indemnification, whereas an "innocent plaintiff" that sued the wrong party might be left without recourse.

In light of the foregoing, the court affirmed the verdict against Walmart.

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Limitations, and CAPEX and Taxes! Oh, My!

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Recent cases decided by the Ontario Superior Court should cause parties to take a closer look at long-used "typical" commercial lease provisions.

Of Limitations and Reconciliations

Consider the typical net lease: The tenant, throughout the term, pays the landlord a minimum rent every month, together with an amount that has been estimated in advance for common area maintenance costs and real property taxes. The parties agree that they will adjust the estimated amounts within a certain period of time after the actual amounts become known. So just how long can the landlord take to reconcile the estimates and the actuals before it is barred from doing so? The answer might surprise both tenants and landlords.

In a recent case in front of the Ontario Superior Court of Justice, A*yerswood Development Corporation v. Western Proresp Inc.* (2011 ONSC 1399), the court considered this very issue. Before the court was a lease that contained the following language:

> Wherever under this lease the Tenant is to pay its proportionate share, the amount thereof may be estimated by the Landlord for such period as the Landlord may from time to time determine, and the Tenant covenants and agrees to pay unto the Landlord the amounts so determined in monthly installments, in advance, during such period and with other rental payments provided for in this lease. As soon as practicable after the end of such period, the Landlord shall advise the Tenant of the actual amounts for such period and, if necessary, an adjustment shall be made between the parties.

The parties had entered into a lease in May 2001, for an initial term of five years. Throughout the term, the tenant paid minimum rent as set forth in the lease and the estimated amounts for common area maintenance ("CAM") charges and taxes, as provided by the landlord. After the lease had expired, the tenant remained in the premises while the parties attempted to negotiate a lease; during that time, the tenant continued to pay minimum rent and estimated charges as it had done during the term. The tenant annually requested the actual amounts owing for CAM charges and taxes, but was not provided with a reconciliation statement until after the lease had expired and the parties had failed to come to terms on the renewal, in December 2007. Upon receiving the bill for the reconciled amounts, the tenant denied its liability, asserting that the landlord was barred by the *Real Property Limitations Act* (Ontario) and the provisions of the lease, given that the landlord had not reconciled the amounts "as soon as practicable" after the end of each period.

In a surprise twist, however, the court found in favour of the landlord, and dismissed these arguments. First, the court noted that the lease did not define the "period" over which the amounts at issue could be estimated. If the parties had intended to define the period, they would have done so, in the court's opinion. The court found that the landlord had selected a period ending in December 2007, and had billed the tenant accordingly. The inference, of course, was that it was open to the landlord to do so, given the open-ended wording in the lease. Second, the court noted that § 17(1) of the *Real Property Limitations Act* (Ontario) provided that arrears must be claimed within six years after they became due. Rather than becoming due after they were accrued—which may have been the intuitive answer—the court found that the amounts did not become due *until they were billed*, namely in December 2007.

Ayerswood highlights the need for tenants, in particular, to pay even greater attention to the additional rent and reconciliation provisions in their leases. While flexibility is important, the landlord in *Ayerswood* was certainly aided by loose drafting. A prudent tenant will insist on annual reconciliations of additional rent amounts, and will ensure that the lease clearly outlines the consequences to the landlord for failing to deliver reconciliations within that timeframe.

CAPEX: What Does That Mean, Exactly?

Landlords and tenants often think they are on the same page when discussing the treatment of capital expenditures ("CAPEX"). The general consensus is that these expenses are so large that they should not be charged fully in the year in which they are incurred, but rather excluded altogether or amortized over the life of the asset in question. But what exactly is a "capital expenditure"? Parties often discover to their surprise that they have different definitions of this "commonly understood" term.

In the case of *RioCan Holdings Inc. v. Metro Ontario Real Estate Limited* (2012 ONSC 1819; appeal dismissed, 2012 ONCA 839), the Ontario Superior Court considered whether a large-scale parking lot repaving project was recoverable by a landlord. RioCan, the landlord, resurfaced the pavement of the parking lot at its shopping centre in order to correct some cracking and distress created by general wear and tear. Although it maintained that it was under no obligation to do so, RioCan then amortized those costs over 20 years and charged Metro its proportionate share of those costs. Metro paid its proportionate share for a few years without complaint, but then had an apparent change of heart, and alleged that the costs were capital expenditures for which it should not be liable. The lease itself allowed recoverability of paving repairs, except for those "expenditures, which by accepted accounting practice" were of a "capital nature." Although the parties agreed that capital expenses should be excluded, it turned out that they had very different ideas about what, in fact, constituted a capital expense—in no small part, because they had differing ideas of which accounting practices should govern the determination.

For its part, Metro argued that the lease should be governed exclusively by generally accepted accounting principles (GAAP). Under GAAP, an item would be considered "capital" if it "enhanced the service potential" or was a betterment of the asset; for example, where the associated operating costs are lowered, or the life or useful life of the asset is extended. In this light, Metro argued that by so substantially repairing the parking lot, RioCan had extended the useful life of the asset and the expenditure should thus be considered capital in nature.

RioCan, in contrast, argued that while "accepted accounting practices" might include GAAP, they could also include tax accounting practices that were not inconsistent with GAAP. Under tax accounting principles, RioCan argued that one of the key factors considered by the Canada Revenue Agency in determining whether an expense was capital in nature was whether it served to restore an asset to its original condition or to materially improve the asset beyond its original condition. The former would be considered a repair, while the latter would be considered a capital expense.

In RioCan's view, the rehabilitation simply restored the parking lot to its close-to-new condition. Further, RioCan argued that, under tax accounting practices, a capital expense should be one that brought a future economic benefit to the asset owner. RioCan insisted that it was not profiting from the parking lot or benefiting from any increased shopping centre revenues as a result of the parking lot repair. Finally, although RioCan agreed that GAAP looked primarily to extension of the life of the asset, RioCan insisted that Metro was looking at the wrong asset—the relevant asset to RioCan's accounting was the shopping centre as a whole, and the parking lot rehabilitation did nothing to extend its life.

The court agreed with RioCan that the failure of the lease to bind the parties specifically to GAAP meant that GAAP was not determinative, although it could be instructive. However, the court rejected RioCan's argument that the relevant asset was the shopping centre, holding instead that the relevant asset was the parking lot. RioCan's internal accounting practices, which treated the relevant asset as the shopping centre and amortized the cost of the repair to reduce overall chargebacks, were irrelevant in the court's view. The dispute was about the parking lot, and the rehabilitation undoubtedly extended the life of the parking lot. Furthermore, the indirect economic benefits to RioCan—in the form of lower operating costs, attracting new tenants, retaining old tenants and complying with the landlord's lease obligations—were sufficient to establish an economic benefit to the landlord such that the expense could be considered of a capital nature even under tax accounting practices. It was not necessary to directly link revenue to expense to prove a capital expenditure. On the facts before it, whether one used GAAP or tax accounting practices as the determining method, the court found that the parking lot repairs were of a capital nature and not recoverable by the landlord.

This case underlines the necessity of ensuring common understanding in drafting and interpreting leases, particularly where a lease excludes recoverability or requires the amortization of capital expenditures. The best way for parties to accomplish this is to define terms properly and discuss intent before the lease is signed; ideally, the lease will explain what is meant by a capital expenditure and provide examples. Alternatively, parties may wish to consider a monetary threshold for expensing repairs fully in the year in which such expenses are incurred. For example, the parties may decide that any expenditure over C$200,000 must be amortized over the useful life of such item or a specified term, such as 10 years. Finally, parties should take care to identify the appropriate accounting standards that will govern any such determination in advance—whether GAAP, International Financial Reporting Standards or tax accounting standards—and understand the resulting treatment of capital and other expenditures thereunder.

Dangers of "Left-Over" Tax Language in Leases

It is not uncommon for standard commercial leases to allow for the determination of a tenant's share of realty taxes with reference to separate assessments, notwithstanding that separate assessments have not been available in Ontario since 1998. However, the recently decided case of *Terrace Manor Limited v. Sobeys Capital Incorporated* (2012 ONSC 2657; appeal dismissed, 2012 ONCA 782) underscores the need for landlords to look more closely at their standard form leases.

The facts of the case in front of the Ontario Superior Court were relatively simple. The lease provided, as many still do, that if separate tax assessments for the leased premises were not made available, the parties would use reasonable efforts to have them made available—and failing that, would obtain "sufficient official information" to determine what such separate assessments would have been if they had been made. If a separate assessment were not available, the tenant would be responsible for its "share" of taxes in respect of the leased premises. The tenant's share would be determined by the landlord reasonably and equitably, having regard to the generally accepted method of assessment and applicable elements utilized by the lawful assessment authority in arriving at the assessment of similar developments, if known. The tenant would not be

required to pay more than its proportionate share of such taxes. The landlord had charged the tenant on a proportionate share basis from 1998 to 2003, when the tenant disputed the allocation, whereupon the landlord began to charge the tenant on an assessed-value basis until 2009. In 2009, the landlord then renewed its attempts to obtain recovery on a proportionate share basis.

Both parties acknowledged that separate assessments were no longer available. However, Sobeys asserted that sufficient "official information"—namely, the Municipal Property Assessment Corporation's (MPAC) working papers—existed in order to permit the parties to proceed on this basis. The court held that MPAC's working papers and valuation records were official and sufficient to permit the parties to determine what the separate assessment would be, had it been made, because such papers contained "all of the information necessary to work out how the current value was calculated for each of the units." Moreover, the court noted that it was untenable for the landlord to argue now that this method was unreliable when it had charged the tenant for half a decade on this basis. Although the lease stated that the tenant would not pay more than its proportionate share, this was the ceiling on its recovery, and the landlord could not simply assume that proportionate-share recovery was the default, particularly when the lease required its allocation to be made with regard to "the generally accepted method of assessment." Consequently, the court agreed with Sobeys that its share should be determined on an assessed value, rather than on a proportionate-share basis.

Ontario courts had ruled in previous cases (see, e.g., *Indigo Books & Music Inc. v. Manufacturers Life Insurance Company,* 2009 CanLII 11432 (ON SC), and *Sophisticated Investments Ltd. v. Trouncy Inc,* [2003] O.J. No. 3017, among others) that MPAC's working papers were not reliable, and did not create a separate "assessed value" of the premises. In some respects, then, Terrace Manor could be forgiven if it had assumed the court would find that such papers could not be relied upon. Importantly, however, the language in Terrace Manor's lease did not appear to give the landlord any discretion in considering whether the working papers were *reliable* enough to determine a separate assessment; rather, the lease provided that, if *sufficient,* the parties were to use such papers to determine what the separate assessment would have been, had it been made. Further, even if separate assessments were not available, the lease provided that the landlord's determination should be made with reference to assessment methods. These distinctions seemed to make all the difference to the court. Indeed, the Court of Appeal subsequently dismissed the landlord's appeal and confirmed that the "wording of the lease in question differs from that of the leases considered in those cases in significant respects." (at para. 9).

Like the other cases referred to in this article, *Terrace Manor* stresses the need to pay careful attention to the wording in the lease, rather than assume that the parties will simply proceed in accordance with commercial norms. Courts will work hard to give effect to the intent of the parties, *whatever it might be*. While many landlords and tenants are "stuck" with leases that pre-date the elimination of separate assessments, both parties would do well to examine the wording of the lease closely to ensure that recovery of taxes is proceeding in the manner that the parties intended when they first struck the bargain contained therein.

Landlords should also be careful not to compound any recovery problems by carrying over language from prior standard forms of leases into new leases. If the landlord's intent is to charge back taxes on a proportionate-share basis, then it should say so. Needless cluttering of the lease with leftover language from the days when separate assessments were available can have dangerous consequences for landlords.

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The Continuing Capital Costs Debate: *Riocan Holdings Inc. v. Metro Ontario Real Estate Ltd.* and the Implications of New Accounting Standards

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Introduction

The typical shopping centre net lease in Canada requires the tenant to pay all or a share of the landlord's costs and expenses incurred in connection with the maintenance, repair and replacement of the common elements (the "operating costs"). Retailers often take the position that only "expense" items should be included in operating costs, whereas costs "on account of capital" should be excluded. They contend that the tenant's minimum rent payment represents the landlord's return on capital investment, and no capital outlay should be recoverable as additional rent.

The characterization of costs as "capital outlays" vs. "expenses" is not that straightforward. All equipment wears out; eventually, a replacement is more appropriate than a repair. Is the cost of replacing a central cooling plant considered a capital expenditure under a lease? Under most accounting principles, it is. Similarly, the costs for resurfacing a shopping centre parking lot or replacing a roof membrane are often scrutinized for recoverability. While it is true that the expenditures incurred to patch sections of paving or a roof are accounted for differently from those incurred to resurface or replace larger segments or an entire parking lot or roof, which of these expenditures should or should not be recoverable under a net lease? If the lease delineates between capital and non-capital outlays, does this lend any clarity?

The *Riocan v. Metro* Case

The recent decision by the Ontario Court of Appeal in *RioCan Holdings Inc. v. Metro Ontario Real Estate Ltd.*[1] highlights a lack of predictability in determining whether certain expenditures qualify as capital or expense items.

In 2002, the landlord resurfaced the pavement of the shopping centre to remedy cracking and distress caused by wear and tear. The total cost of the work was approximately $431,000. The landlord decided to amortize the cost of the work over 20 years. The landlord billed the tenant for its *proportionate* share of the annual amortized amount.

Under the lease, the tenant, a prominent operator of a chain of grocery stores, was required to pay its proportionate share of repairs and maintenance of sidewalks and paved areas; but "expenditures, which by generally accepted accounting practice are of a capital nature" were excluded. Neither of the terms "generally accepted accounting practice" nor "capital" was defined in the lease.

From 2003 to 2006, the tenant paid its monthly installment of the charges without question. However, in 2007 the tenant reviewed its operating cost statements and concluded that the parking lot work was a capital expenditure that it should not have paid. In 2010, the tenant unilaterally set off the 2007–2008 charges against its total rent and declined to pay any further amounts in respect of the work to the parking lot. The landlord brought an application to the Ontario Superior Court of Justice, seeking payment of the amounts withheld by the tenant.

The landlord claimed that the cost of the work to the parking lot was a repair cost and not a capital expense. The landlord took the position that the phrase "generally accepted accounting practice" in the lease included not only GAAP, but tax accounting principles as well. The landlord noted that, based on tax accounting principles, a capital expense is one that leads to an increase in the future net cash flow of the asset. The landlord maintained that in this case, the asset was the shopping centre, not the parking lot. In the landlord's view, the parking lot was merely a part of the shopping centre and it was appropriate to recognize that parking lots would, over the life of a shopping centre, need to be repaired. The landlord maintained that since the work did not result in a direct increase in rent or revenue for the shopping centre, and since it did not extend the useful life of the shopping centre, it should not be characterized as a capital expenditure.

The tenant took the position that the work to the parking lot was a capital expenditure that was not recoverable. The tenant maintained that the phrase "generally accepted accounting practice" in the lease referred exclusively to GAAP, and that it was not appropriate to use tax accounting principles to determine the proper treatment of the cost, because tax law and practices are based on a totally different framework from GAAP.

The tenant maintained that in accordance with GAAP principles, an item is placed in the capital account if it can be considered a "betterment." The tenant claimed that the work to the parking lot amounted to a betterment because (1) it caused the parking lot to be as "good as new"; (2) it significantly extended the life of the parking lot; and (3) it resulted in a substantial reduction in the landlord's ongoing operating costs. The tenant also claimed that the parking lot was a major component of the property, which had the capacity to indirectly contribute to the future net cash flow of the shopping centre.

The Decision

The court ruled in favour of the tenant, holding that a significant increase in the useful life of a major component of the property will lead to an increase in the useful life of the property as a whole and of its service potential. The court held that the improved parking lot indirectly contributed to future net cash flow to the landlord by: (1) allowing the landlord to comply with its lease obligations and avoid claims by tenants; (2) helping the landlord to retain existing tenants and attract new tenants; (3) enhancing the economic value of the property; and (4) minimizing the number of possible claims from visitors to the property resulting from injuries sustained in the parking lot.

The court also found that the landlord's decision to amortize the cost of the work over a period of 20 years was evidence that the landlord itself considered the work to be a capital cost. The court concluded that the work to the parking lot was a capital expenditure and that, pursuant to the terms of the lease, the cost should not have been passed on to the tenant. The landlord's appeal to the Ontario Court of Appeal was dismissed.

Recent Canadian Accounting Methodology Changes

In 2011, Canada's accounting regime was significantly altered in that the previous financial reporting standards for companies [GAAP as determined by the Canadian Institute of Chartered Accountants (CICA) Handbook] were replaced by International Financial Reporting Standards (IFRS), which are a set of standardized accounting standards developed by the International Accounting Standards Board. The adoption of IFRS for the reporting of financial matters by Canadian entities has triggered some consternation in predicting the recoverability of capital expenditures as operating costs under net leases.

To the extent that a lease permits the recovery of certain capital expenditures, it is quite common to find that the amount to be paid by the tenant is required to be calculated "in accordance with GAAP." With the imposition of the new accounting standards, the following issues have arisen:

(1) Is the definition of "GAAP" static (i.e., reflecting only GAAP as it exists/existed as at the date of the lease) or fluid (i.e., reflecting GAAP as amended from time to time)? In the absence of clear lease wording, the answer would depend on lease interpretation principles. In Canada, however, as of 2011, a reference to GAAP *may* import an IFRS meaning (that may not have been intended).

(2) How is the recoverable portion of a cost to be determined if it is to be calculated in accordance with "new GAAP" (assuming that a reference to GAAP is fluid and can now be taken to mean IFRS)?

    (i) The application of the IFRS requirements depends on the organization type. Publicly Accountable Enterprises are now required to follow IFRS, while Private Enterprises have the option of adopting IFRS or the new private enterprise standards. Not-for-Profit Organizations have the option of applying IFRS or the existing CICA Handbook accounting standards for not-for-profit organizations. Federal, Provincial, Territorial and Local Governments follow the Public Sector Accounting Handbook, not IFRS. In the case of a lease stipulating that certain capital expenditures are recoverable "in accordance with GAAP," there is a question as to whether the applicable standard is to be based on the nature of the Landlord entity or of the Tenant entity.

    (ii) There are a number of significant differences between IFRS and the former GAAP standards (as set out in the CICA Handbook), including:

A) **Recognition of Value**

Under IAS 40, an investment property is recognized as an asset if and only if probable future economic benefits will flow to the entity and the cost of the item can be measured reliably. Shopping centres produce investment income and are therefore considered to be investment properties (they are not property used by the business, such as a manufacturer using lands and buildings owned by it to house its factory).

Under IAS 40, the value of an investment property is initially measured at its cost (including transaction costs). Subsequent to initial recognition, IAS 40 permits entities to choose either:

(i) A fair value model, under which an investment property is measured, after initial measurement, at fair value with changes in fair value recognized in profit or loss; or

(ii) A cost model, which requires an investment property to be measured, after initial measurement, at depreciated cost (less any accumulated impairment losses)

By contrast, the CICA Handbook (Section 3061) requires an entity, even one that owns investment property, to carry property, plant and equipment on the cost basis subsequent to their initial recognition. Revaluation is prohibited.

B) **Capital costs and repairs and maintenance under the "cost model" vs. the "fair value model"**

In determining the carrying amount of investment property under the fair value model, an entity does not double-count assets or liabilities that are recognized as separate assets or liabilities. For example:

(i) Equipment (such as escalators or air-conditioning) is often an integral part of a building and is generally included in the fair value of the investment property, rather than recognized separately as property, plant and equipment.

(ii) If a store or restaurant is leased on an equipped basis, the fair value of the store or restaurant generally includes the fair value of the equipment, because the rental income relates to the equipped store. When equipment is included in the fair value of investment property, an entity does not recognize that equipment as a separate asset.

An entity that chooses the cost model, after initial recognition, must measure all of its investment properties in accordance with the cost model (which, in general, provides that each class of property, plant and equipment be carried at cost less accumulated depreciation) and depreciate that cost over the remaining useful life.

However, under the fair value model, if a shopping centre's roof is replaced, the carrying amount of the shopping centre will not necessarily increase unless the new roof increases the fair value of the shopping centre. However, under the cost value model, the replacement of that same shopping centre's roof would likely increase the carrying value of the shopping centre. From a cost recovery perspective, an example is apt: A shopping centre resurfaces its parking lot at a cost of $100,000. The resurfacing has an estimated useful life of five (5) years. The shopping centre is subject to leases that provide that cost of resurfacing the parking lot, charged in accordance with GAAP, is recoverable.

Under the cost model, when the $100,000 is spent, the expenditure would be capitalized; i.e., the $100,000 expenditure would be amortized over five (5) years at $20,000 per year (leaving aside any consideration of interest accruing). So, at the end of the first year, $20,000 would be amortized (included in Operating Costs) and recovered from tenants under net leases that permit recovery of capital expenditures "on an amortized/depreciated basis in accordance with GAAP."

By contrast, there would be no amortization under the fair value model. Instead, the carrying value of the shopping centre at the end of the year would be compared to the fair value at the end of the prior year and any changes in fair value recognized in profit or loss. In this scenario, the $100,000 cost would likely be expensed in its entirety in the first year.

If the expenditure occurred in the year before the new IAS standard was adopted, and the landlord used GAAP to recover $20,000 from its tenants in year 1 but then chose the fair value model upon adopting the new standard, the remaining unamortized $80,000 of resurfacing costs would likely never be recoverable.

This simplified scenario assumes that the reference in the leases to GAAP will be construed as incorporating IFRS, whereas it is possible that the leases might have been written to specify "GAAP as of the date hereof," and it is also possible that a court might interpret a reference to GAAP in a lease pre-dating IFRS as limited to GAAP as it existed as of the date of the lease.

Due to the complexity of GAAP, as modified by IFRS, it is suggested that the determination of how and which costs should be considered as capital costs, and whether any portion of them are to be recovered under a net lease, should not be left to "GAAP." Any recoverability should be spelled out in clear lease terms (e.g., "amortized on a straight-line basis to zero with interest at a rate of X% over the useful life of the replacement"). Furthermore, in general, it is probably best to avoid a reference to "capital costs" as a category of costs susceptible to one treatment or another, because the meaning of this terminology is unpredictable.

The reality is that accounting standards are not necessarily germane to shopping centre cost concepts, for purposes of determining the recoverability of costs under net leases.

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[1] [2012] ONSC 1819 (Ont. S.C.J.), as aff'd by 2012 ONCA 839 (Ont. C.A.).