

# DOES TURNING OFF THE LIGHTS MEAN TURNING ON A LAWSUIT?

## A LOOK AT IMPLIED COVENANTS OF CONTINUOUS OPERATION

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Everyone knows that we are living in tough economic times. Many retail businesses are looking for ways to cut costs. In some cases, national, regional and local retailers may decide to close some stores to focus resources on more profitable units. However, many retailers lease space that is subject to long-term leases. Rather than break the lease, these retailers may make the economic decision to keep paying the rent on a closed, or “dark,” store. However, there can be serious legal consequences for doing so; specifically, the retailer could be subject to a suit for breach of an implied covenant of continuous operation.

Even if the tenant continues to pay rent, a landlord may be very unhappy if a retailer closes shop. First, a vacant store can have a major detrimental impact on the viability of a shopping center. Other retailers may be hesitant to lease space in a shopping center with a high-vacancy rate. Also, if the shopping center falls below certain occupancy levels or if certain key tenants leave, it is not uncommon for other tenants in the shopping center to have remedies against the landlord, such as reduced rent or the right to terminate. Second, many leases provide the landlord with two types of rent: (1) a fixed amount of base rent (“Fixed Rent”); and (2) a percentage of the tenant’s sales (“Percentage Rent”). If a store closes, the landlord may continue to receive the Fixed Rent, but the landlord will not get any Percentage Rent if the store is closed.

Ideally, a commercial lease should directly address the consequences of the tenant ceasing operations. However, many leases are silent on this issue. In those cases where the lease is silent, the landlord can argue

that there is an implied covenant of continuous operation. An implied covenant of continuous operation, sometimes referred to in the industry as an “implied covenant against going dark,” is the concept that the tenant has an obligation to keep its store open for business for the duration of the lease.

Unfortunately, there is no uniform approach utilized by states to determine whether there is an implied covenant of continuous operation. However, there are certain factors that are frequently considered to determine if it is equitable to force a retailer to keep its doors open.

### WHETHER THERE IS SUFFICIENT FIXED RENT TO COMPENSATE THE LANDLORD

The single most important factor in most states is whether the landlord is adequately compensated with Fixed Rent. If the Percentage Rent is a major component of the rent formula, courts are more likely to imply a covenant of continuous operation. For instance, suppose a lease calls for \$1,000.00 a year in Fixed Rent and 7.5% of gross sales as Percentage Rent. If the Percentage Rent typically pays \$99,000.00 a year, closing the store essentially reduces the landlord’s rent by 99%. This scenario would weigh heavily in favor of finding an implied covenant of continuous operation.

### WHETHER THE TENANT HAS AN UNFETTERED RIGHT OF ASSIGNMENT OR SUBLETTING

If the tenant can assign or sublet the premises without permission from the landlord, then a court is less likely to find an implied covenant of continuous operation because the tenant could walk-away from the premises by assigning or subleasing



to anyone. On the other hand, if the lease restricts the tenant's ability to assign or sublet, then the implication is that the parties intended the tenant to occupy the space during the lease.

#### **WHETHER THE LEASE CONTAINS A RESTRICTION ON THE TENANT'S PERMITTED USES OF THE LEASED PROPERTY**

If the lease restricts the tenant's permitted use of the leased property, some states interpret this to mean that the parties intended the tenant to be open and operating in a manner consistent with the limited uses. Conversely, if the lease permits virtually any use, then it implies that the parties did not contemplate that the tenant would always use the premises for a retail store.

#### **WHETHER THE LANDLORD IS SUBJECT TO A NONCOMPETITIVE RESTRICTION**

Some leases prohibit the landlord from leasing other space to competitors of the tenant. Courts may find such a clause to weigh in favor of finding an implied covenant. The parties must have intended the tenant to operate its business continuously if the landlord is restricted from leasing to similar businesses. For instance, if the tenant has the exclusive right to operate a sporting goods store, but the sporting goods store closes, then the landlord is prohibited from replacing the tenant with another sporting goods store. The implication is therefore that the parties intended the tenant to stay open to operate a sporting goods store in the shopping center.

#### **WHETHER THE TENANT HAS THE RIGHT TO REMOVE THE FIXTURES**

Some states examine whether the tenant has the right to remove fixtures from the premises during the term of the lease. The typical rationale is that the lease probably does not contain an implied covenant of continuous operation if the tenant has the right to remove fixtures from the leased property during the lease. In other words, if the tenant can take its fixtures out of the building, then the tenant must not have an obligation to keep its business open.

#### **WHETHER THE LEASE IS COMPREHENSIVE**

Some states look at the comprehensiveness of the lease agreement. If the lease is a comprehensive and detailed agreement, then it is less likely that the parties omitted an intended term such as a covenant of continuous operation. Also, if the lease was

heavily negotiated, then it is less likely that the parties accidentally omitted a term. Therefore, a comprehensive, detailed, and thoroughly negotiated lease agreement weighs against finding an implied covenant of continuous operation.

#### **WHETHER THE PARTIES WERE SOPHISTICATED**

States that consider the sophistication of the parties typically hold that an implied covenant of continuous operation is less likely between sophisticated parties. Sophisticated parties are less likely to omit an intended term, such as a covenant of continuous operation. Sophisticated parties also have the opportunity to hire advisors, such as attorneys or commercial real estate brokers, who know or should know about a covenant of continuous operation and can assure that the issue is addressed expressly.

#### **WHETHER THE PARTIES INCLUDED AN EXPRESS COVENANT OF CONTINUOUS OPERATION IN UNRELATED AGREEMENTS WITH THIRD PARTIES**

A couple states examine whether the parties included an express covenant of continuous operation in unrelated agreements with third parties. These states rationalize that the presence of an express covenant in other leases indicates that the parties knew how to draft a covenant of continuous operation and include it when desired. Therefore, if there is an express covenant in third-party leases, then this factor weighs against finding an implied covenant.

#### **WHETHER THE LANDLORD MADE A SUBSTANTIAL INVESTMENT IN THE LEASED PROPERTY FOR THE TENANT**

If the landlord made a substantial investment to attract a particular tenant, such as a custom build-out, courts are more likely to find an implied covenant of continuous operation. This is particularly true if the custom build-out is not suitable for other tenants.

#### **WHETHER THE TENANT IS AN ANCHOR IN THE SHOPPING CENTER**

An anchor tenant is a popular retailer that is likely to draw traffic into the shopping center, such as Wal-Mart, Target, Dillard's, JC Penney's, etc... These retailers sometimes receive preferential treatment from the landlord because they are essential to the success of the shopping center. If the tenant is an anchor in the shopping center, or there is some other strong economic dependence on the tenant (other than pay-

ing rent), then courts are more likely to imply a covenant of continuous operation.

#### **WHETHER THE LEASE IS LENGTHY**

Several states examine whether the lease is lengthy. However, states weigh this factor differently. Some states weigh this factor against implying a covenant, especially when the lease is a ground lease. In other words, if the lease is for a large number of years, then it is more likely that the tenant's business interests or plans may change during the lease and necessitate a shutdown. Other states, however, view this factor differently. Some states interpret a long-term lease as meaning that the parties intended the tenant to remain in business the entire time.

#### **CONCLUSION**

While most states examine some combination of the factors listed above, there is relatively little consistency among the states in interpreting these factors. At the risk of overgeneralizing, most states are relatively hostile to the concept of implied covenants of continuous operation and the landlord has a difficult burden to prove its case. However, a few states, notably Kentucky, Tennessee and Connecticut, are more likely to side with the landlord.

Ideally, every lease should directly address whether the tenant has an obligation to continuously operate during the lease. However, in those instances where the parties fail to express their intent, these factors help guide a court in deciding how to interpret the lease.

For more on implied covenants of continuous operation, see J. Cliff McKinney, *Are You Trying to Imply Something: Understanding the Various State Approaches to Implied Covenants of Continuous Operation in Commercial Leases*, 31 UALR Law Review 427 (2009).



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