DEVELOPMENT NEWS

Freeborn & Peters LLP

Trend Report: Development Issues Our Clients Are Talking About

SECURITY DEPOSITS IN COMMERCIAL LEASES

Security deposits in commercial leases receive a lot of attention during lease negotiations but are quickly forgotten (sometimes, quite literally, in a drawer or safe!). The requirements and restrictions that the law imposes on commercial landlords in handling security deposits vary by state. In Illinois, the statutory law on security deposits only applies to residential leases. Because such little authority exists on how security deposits must be handled in commercial leases in Illinois, the best practice is for the parties to include a detailed and clear clause governing the maintenance and handling of the security deposit. A security deposit clause should discuss triggers to apply the security deposit, limitations on the amount to be applied, interest earned on security deposits and the replenishment requirements if any portion of the security deposit is applied as a result of a tenant default. Some other key topics that should be addressed in a reasoned security deposit clause are:

Commingling of Funds. Tenants typically want their cash security deposits maintained in a separate account so as to provide the tenant with greater assurance that security deposits will be (a) properly transferred to a successor-landlord if the building is sold, and (b) protected in the event of a landlord bankruptcy. Landlords typically prefer to commingle security deposits, as doing so reduces administrative costs and provides the flexibility to utilize those funds for other items.

Return of Security Deposit. Landlords typically want to wait to return security deposits until all of the tenant's obligations have been satisfied and there is no risk of tenant's failure to perform remaining. This may not occur until the final expense and tax reconciliations are completed. Tenants typically prefer to have the security deposit returned when the parties' relationship really ends – i.e., at lease termination and end of occupancy.

Transfer of Security Deposit. Some courts have ruled that security deposits are separate obligations from the lease itself. Thus, the assignment of the lease by one landlord to a successor-landlord would not automatically constitute a parallel assignment/transfer of the security deposit. Therefore, it is in the tenant's best interest to include language in the security deposit clause of their leases, which provides that any transfer of landlord's interest will also include a transfer of the security deposit.

Landlords and Tenants must consider all of these issues in order to craft a comprehensive security deposit provision

PITFALLS OF INSURANCE CERTIFICATES

Parties to contracts that include proof of insurance requirements should be aware of the difference between an endorsed insurance policy and a certificate of insurance. One is a legally binding contract; the other is a piece of paper that is not worth the paper its printed on. Accordingly, parties that wish to be named as additional insured parties on another's policy of insurance should obtain more than just a certificate of insurance that names them as an additional insured.

Recently, courts have come down hard on litigants who have attempted to demonstrate that they were additional insured parties on an insurance policy based upon the "additional insured" section of the certificates of insurance provided by a contracting party. Courts have concluded that the certificates, which can be issued by any insurance broker, are not binding and cannot be relied upon for this purpose. In fact, the general language on a typical form of insurance certificate states on its face that the certificate does not create any binding obligations. This express language precludes a party's reliance on the certificate and the law supports this conclusion.

Consequently, the certificate of insurance is not enough. Additional insured parties must be named within the endorsed insurance policy in order to be covered. Accordingly, contracting parties should require the policyholder to deliver a copy of the full policy or at the very least a copy of the additional insured endorsement naming all requisite parties as additional insureds to the policy at the time of contract execution.

LEASE TRENDS IN TOUGH TIMES

Even in a sluggish real estate market, properties still trade hands. However, as real estate professionals know, first class properties command the most attention and the highest prices as investors look for safe haven investments. To be considered a top tier property, the investment must have top tier leases. But, simply having top tier leases is not enough, the terms of the leases are also being scrutinized more than ever. Termination and cancellation clauses, offsets, indemnification provisions and any other lease term that creates a landlord obligation will certainly be viewed under a microscope. If not drafted correctly, investors may raise the cap rate for the investment or walk away. Accordingly, in tough times like today, it is essential to pay attention to the lease terms - even those that may not have attracted a second glance just a short time ago.

CONSIDERATIONS FOR HOW TO ORDER YOUR MAC

A MAC (Material Adverse Change) closing condition in a transaction agreement aims to assign risk between the contracting parties for the period of time between the signing of a contract and closing of the transaction. Often seen in merger and acquisition agreements, MAC clauses allow buyers to terminate a contract if the business of the company being acquired has seriously faltered or has negatively changed.

Despite strict scrutiny imposed by the courts in interpreting and implementing MAC clauses, inclusion of MAC clauses is on the rise. This increased inclusion of MAC clauses in transaction agreements brings with it a curiosity as to how to draft the best MAC clause. It goes without saying that what constitutes the “best MAC clause” varies depending on whether the clause is being drafted for the benefit of a buyer or for the seller. Researching how MAC clauses are interpreted by the courts in a specific jurisdiction will provide guidance into how to draft a MAC clause. However, regardless of jurisdiction, some general concepts for drafting a MAC clause follow.

Whereas a seller will want a MAC clause to be narrowly drafted with specific carve-outs and defined time periods, buyers will benefit from a more broadly drafted clause provided that the language is not too broadly drafted. Buyers need to balance having a MAC clause so broad as to leave its interpretation completely in the hands of a court with being so narrow as to limit the times when the MAC clause can practicably be applied.

Sellers generally want to carve out general market conditions or conditions that were brought to the buyer’s attention prior to contract execution. In such a case, buyers may wish to except out of such carve outs situations where, regardless of general market conditions, seller or the company to be acquired is still performing at a level disproportionate to general market conditions.

Ultimately, drafting an effective MAC clause varies on a case-by-case basis. When left to interpret the clause, courts often look at the contract as a whole to determine the intention of the parties. Thus, what works in one deal is not guaranteed to work in another deal. A MAC clause can often be the last resort for a buyer to attempt to get out of a contract or a way for a buyer to attempt re-negotiation of a contract price. With so much riding on the provision, parties to a MAC clause should avoid boilerplate language and should instead pay close attention to how their MAC clause is drafted and how it applies to their particular transaction.

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