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Landlord Waived Right to Sue Tenant Without Due Consideration

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In many commercial real estate transactions, landlords and tenants make estoppel certifications representing that certain facts involving their legal relationship are correct.

Some of the more common statements are that a lease exists, that there are no defaults under the lease and that rent is paid to a certain date. These statements are made to "estop" the party making the statement from later raising claims of what it knew or should have known at the time the certification was executed.

In *Retail Brand Alliance Inc. v. Rockvale Outlet Center, L.P.*, the U.S. District Court for the Eastern District of Pennsylvania strictly enforced an estoppel certification contained within a lease assignment agreement that prevented a landlord from filing a counterclaim against its former tenant.

In *Retail Brand Alliance Inc.*, the tenant entered into a retail store lease agreement with the landlord. Under the lease, the tenant was allowed to assign its interest in the lease to a third party only with the landlord's consent.

When the parties entered into the lease, the store was an empty shell. Both the landlord and the tenant had respective duties in the lease to turn the shell into a retail store. The landlord was required to install the basic features and layout of the store, and the tenant agreed to "fit out" the space at the landlord's expense. The tenant was given a \$340,000 "fit out" allowance under the terms of the lease.

Before the landlord could begin construction of the space, the tenant was required to provide the landlord with detailed architectural plans and specifications describing the construction work that both parties would perform to fulfill their contractual duties.

The landlord soon began work based on the plans and specifications provided by the tenant. Shortly thereafter, the landlord discovered that these plans and specifications contained "latent defects, errors, omissions and inaccuracies and were false and misleading."

The landlord retained the services of another architect to correct the plans and specifications at an additional cost of \$100,000. Due to the associated delay in the completion of the store's construction, the landlord did not collect any rent during this period of time.

Within a year after the store opened for business, the tenant, with the landlord's consent, assigned its interest in the lease to another retail operator. Prior to doing so, the tenant requested reimbursement of the \$340,000 tenant allowance the landlord owed. The landlord did not pay that amount prior to executing the assignment agreement.

As part of the assignment agreement, the landlord executed an estoppel certification representing that the tenant did not owe any amounts under the lease and that there were otherwise no uncured defaults committed by the tenant under the lease.

The Case

After assigning the space, the tenant filed a complaint in the federal district court to recover the \$340,000 the landlord owed for the tenant allowance. The landlord filed a motion to dismiss the case, arguing that the tenant assigned its interest in the allowance to new retail operator in the space when it executed the assignment agreement. The district court found this reading contrary to the plain language of the assignment agreement and denied the landlord's motion to dismiss.

The landlord then answered the complaint and added a counterclaim against the tenant for, among other things, breach of contract. In its breach of contract claim, the landlord sought the excess renovation costs it incurred in converting the retail space and the damages flowing from the delay in the construction of the retail space. The tenant moved to dismiss all of the counterclaims.

The district court found that the estoppel certification in the assignment agreement barred the landlord from attempting to collect the sought-after expenses, since it represented that there were no uncured defaults by the tenant when it executed the agreement in the first place.

The district court based its decision on the plain language in the certification. It pointed out that through the estoppel certification, the landlord expressly represented there were no "uncured defaults" attributable to the tenant under the lease or conditions that "would reasonably be expected to result in a default" by the tenant. The district court noted that the landlord incurred the excess renovation costs sometime before the store opened, and the costs predated the assignment by almost a year.

The district court then rejected the landlord's attempt to ignore the plain meaning of the estoppel certification. In opposing the motion to dismiss the counterclaim, the landlord argued that the estoppel certification was invalid and unenforceable both because the tenant fraudulently induced the landlord into entering the assignment agreement and because of its unilateral mistake.

The landlord first argued that the tenant fraudulently induced the landlord into making the estoppel certification through the tenant's unspoken suggestions that the tenant would not pursue payment for the tenant allowance if the landlord consented to the assignment of the lease. In support of its theory, the landlord pointed out that the landlord stopped payment of the allowance to the tenant after learning that the tenant intended to close the store, file for bankruptcy and thus "dump" its lease, and that the tenant never sought payment of the allowance or mentioned it again until after the assignment agreement was fully executed.

The district court rejected the landlord's fraudulent inducement argument based upon the legal theories of parol evidence rule and ratification.

The parol evidence rule "bars prior or contemporaneous oral representations or agreements about a subject that is specifically dealt with in a written contract that covers the entire agreement of the parties, absent fraud, accident or mistake." As explained by the district court, parol evidence is generally only permitted to show "fraud in the execution" and not "fraud in the inducement."

In contrast to "fraud in the execution," which deals with terms of the written agreement which are omitted by fraud, accident or mistake, "fraud in the inducement" occurs when "the party proffering evidence of additional prior representations does not contend that the parties agreed that the additional representations would be in the written agreement, but rather claims that the representations were fraudulently made and that but for them, he or she never would have entered into the agreement."

Since the landlord could not establish that the parties intended to include the tenant's waiver of the allowance in the assignment agreement, the district court found the counterclaim was barred by the parol evidence rule because the landlord's theory amounts to "fraud in the inducement" and not "fraud in the execution."

The district court found that the fraudulent inducement claim also lacked any merit because the landlord had ratified the assignment agreement through its conduct over the past year. The district court emphasized that since "[e]stablishing fraud in the inducement does not render the transaction void but only voidable, "[t]he defrauded party can ratify the contract if 'it accepts the benefits flowing from it, or remains silent, or acquiesces in the contract for any considerable length of time after the party has the opportunity to annul or avoid the contract.'"

The district court pointed out that the landlord has consistently accepted the benefits of the agreement by treating the current retail operator as a tenant and accepting rent payments.

The district court next rejected the landlord's argument of unilateral mistake. In Pennsylvania, a contract may be invalidated for a unilateral mistake if the mistake is a "basic assumption" or the essence of the contract and the party alleging the mistake did not bear the risk of the mistake by being aware at the time the contract is made that the party has "limited knowledge" of the facts to which the mistake relates and treating this limited knowledge as sufficient.

Once a party has established the basic elements of a unilateral mistake, there are two exceptions to the general rule that a party must live with the result of the unilateral mistake. First, a unilateral mistake as to the contract can invalidate an agreement procured through fraud. Second, a contract based on unilateral mistake can also be rescinded "if the other party knows or has reason to know of the unilateral mistake, and the mistake, as well as the actual intent of the parties is clearly shown."

The district court doubted whether the landlord could establish the core elements of unilateral mistake. The district court noted that the mistake concerned payment of the renovation costs, which did not go to the basic assumption to assign the lease to a new tenant.

Moreover, the district court concluded that the landlord "bore the risk of its mistake by treating its limited knowledge as sufficient" because the landlord, a sophisticated party, "believed" that the tenant shared its belief about the tenant allowance but never sought clarification or memorialized this "agreement" in writing.

The district court also stated that even if the landlord court could establish the elements of unilateral mistake, the landlord could not show that it fell into one of the two narrow exceptions outlined above.

In its counterclaim, the landlord did not allege that the tenant procured the assignment through fraud, but rather that the tenant knew or should have been aware of the landlord's mistaken assumption that the parties had agreed that the landlord would consent to the assignment if the tenant would forgo the allowance. The district court noted that the landlord puts forth no evidence that the tenant's silence concerning payment of the allowance is the same as knowing that the landlord was mistaken about a basic assumption of the contract.

LESSONS LEARNED

Retail Brand Alliance Inc. is the classic example of a party to a contract ignoring the reality of its situation. At the very least, the landlord knew it could owe the \$340,000 allowance to the tenant. Rather than directly dealing with this potentially uncomfortable situation, the landlord believed that the situation would somehow disappear. This mistaken strategy is even more damning considering that the landlord presumably had more leverage than the tenant prior to the execution of the assignment agreement.

The landlord did not have to allow the tenant to assign the lease. Moreover, the tenant may have had some legal liability to the landlord for the substandard plans and specifications provided by the tenant's architect during the construction of the store.

Either way, the landlord basically gave away its rights under the lease for nothing instead of shielding itself from any further liability.

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