Alert
March 15, 2017

Real Estate Alert
News Concerning Recent Developments in Real Estate Laws and Regulations

COZEN O'CONNOR

Recent Federal Court Decision Adds Clarity to "Ordinary Wear and Tear" Lease Provisions

Most veterans of commercial leasing are familiar with the concept of a surrender clause but might not have been tasked with negotiating its meaning following lease expiration. A recent federal court decision sheds light on this significant, but often overlooked, issue.

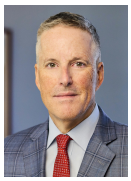
Generally, a surrender clause is intended to define the requirements for the tenant's surrender of the premises at the end of the lease term. While commercial leases in most jurisdictions include an implied covenant for the tenant to surrender the premises in substantially the same condition as they were received, most leases contain an express provision setting forth the surrender requirements. A typical provision of this nature reads like this:

> Upon the expiration or other termination of this lease, whether by lapse of time, cancellation or termination, forfeiture, or otherwise, tenant shall immediately quit and surrender possession of the premises to landlord in good condition and repair, ordinary wear and tear, and damage from fire or other casualty or peril excepted, in broom clean condition with all unattached trade fixtures, furniture, and personal property removed, except as otherwise provided in this lease.

These provisions raise the question: What exactly does "ordinary wear and tear excepted" mean in the context of returning the premises to the landlord in good condition and repair? The importance of this carve-out from the obligation to return the premises in substantially the same condition as the tenant received them is particularly perplexing in the circumstances involving a long-term leasing history between the landlord and tenant. A part of the answer to this question turns on the extent and intensity of tenant improvements, of course. For fit outs requiring extensive improvements to accommodate the tenant's equipment and/or use, such as reinforced walls and flooring or special life-safety systems, landlords typically require the tenant to restore the premises to their original condition. But what does restoration mean in less obvious and more pedestrian uses, such as common retail uses? If the tenant occupies the premises for 15 or 20 years, or longer, must the tenant not only remodel them but also bring them up to current building code standards?

That very issue is the subject of a recent federal court decision interpreting Minnesota law in *H.F.S. Properties v. Foot Locker Specialty, Inc.* (D. Minn. 2/2/2017). The case involved a landlord-tenant dispute regarding the Woolworth Building (building) in St. Paul, Minn., in which Foot Locker Specialty, Inc. (Foot Locker) was the tenant. Foot Locker, then known as F.W. Woolworth, constructed the building under a lease from 1920. Generally, HFS claimed that Foot Locker failed to keep the building in good repair, and the court considered the measure of damages for the landlord's claims. Minnesota law — consistent with that of most states — allows a landlord to withhold amounts from the tenant's security deposit that are "reasonably necessary" to restore the leased premises to their condition at the start of the tenancy, excluding ordinary wear and tear. However, Minnesota courts apparently had never considered the kinds of wear and tear to a leased premises that should be considered ordinary.

Without specific reference to objective standards for normal wear and tear, the concept of surrendering the premises in good condition is naturally ripe for controversy. In *H.F.S. Properties*, the court was required to interpret two separate leases for Foot Locker's use of the building. The more current lease (from 1949) contains a surrender clause with a specific wear and tear exception, while the older lease (from 1920) contains the more general clause stating that the tenant shall keep the building in good order and repair during the term of the lease, with no wear-and-tear exception and no reference to the tenant's obligation upon surrender.



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The court observed that because both leases were of very long terms, Foot Locker's surrender of the leased premises with no ordinary wear and tear exception would require a complete renovation at lease end. In fact, the landlord argued that Foot Locker was required to surrender the premises in a condition such that the municipality would issue a certificate of occupancy to the owner. This interpretation would require Foot Locker to make improvements to the premises that satisfied 2015 municipal zoning and building codes and the current state fire code. By the end of the term, the building had been vacant for nearly 15 years, could not be legally occupied, and contained 110 code violations. The landlord demanded that Foot Locker pay $11 million to cure the deficiencies, including new elevators, stairwells, windows, plumbing, sprinklers, and more.

The court concluded that Foot Locker was only responsible for the cost of performing repairs required by the lease. This approach was advanced by the Wisconsin Supreme Court in *Lindsay Brothers v. Milwaukee Cold Storage Co.*, 207 N.W.2d 639, 643 (Wis. 1973), and contemplates that deterioration of the leased premises occurs naturally due to time and use despite ordinary care for their preservation. Under this reading, all that Foot Locker was obligated to do under the lease was to surrender the building in "good condition, wear and tear … excepted." Upon making repairs meeting this standard, Foot Locker would have complied with its surrender obligation under the leases even though the building would not necessarily have been compliant with 2015 city and state occupancy and fire codes.

Thus, the court rejected the landlord's interpretation that the phrase "good order and repair" requires a tenant to bear the cost of code-compliance work required at lease expiration. The fact that the landlord sought to change the use of the building by occupying it, requiring more than 100 repairs, had no bearing on Foot Locker's obligations, the court concluded.

The *H.F.S. Properties* decision comes as good news for long-term commercial tenants, removing at least some doubt as to what their obligations will be upon surrender of the premises. On the other hand, it stands as a reminder to landlords that they must be explicit when drafting surrender clauses if they want to hold tenants responsible for remediation efforts at lease end.

To discuss any questions you may have regarding the issues discussed in this Alert, please contact a member of the Cozen O'Connor's Real Estate Department.