Contributing Writers

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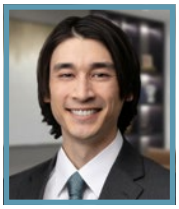

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ROXANA TOFAN (P. 50) is the founder and principal broker of Clear Integrity Group, specializing in commercial real estate across Texas, Oklahoma, South Carolina, Ohio, and Tennessee. With a focus on multifamily and commercial properties, she excels in acquisitions, dispositions, and property management, particularly in transforming underperforming assets through strategic operations and team building. Roxana is a dedicated community advocate and enjoys traveling, spending time with her family, and supporting charitable causes. She has also served as a contributing editor for **thenetwork** for over 15 years, covering topics including commercial real estate, business ownership, sports, and travel.

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Some people love you only as long as you fit in their box. Never be afraid to shove that box up their ass!

LEGAL VIEW

BY
MERRICK (MAX)
HAYASHI

LESSOR BEWARE!

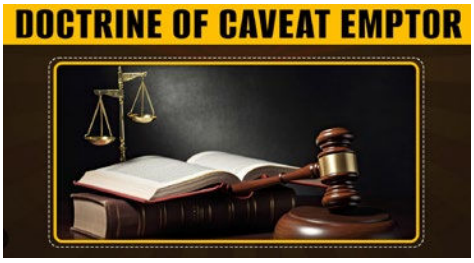
NAVIGATING *CAVEAT EMPTOR* IN THE CONTEXT OF COMMERCIAL LEASING

Across the United States, businesses ranging from sole proprietorships to complex corporations routinely encounter—and must overcome—a plethora of operational challenges. For some, this could involve replacing employees or improving outdated policies and systems; For others, this may involve graver situations like defending against class-action lawsuits or navigating the floor-dropping effect of a suspended license. In any case, running a business is not easy—and savvy business owners must understand the scope of risks behind their decisions in order to survive, particularly those that are at once costly, early in the life of a business, and critical to serving a business's most basic needs.

For businesses that rent property, whether voluntarily or necessitated by factors like size, zoning, or proximity to consumers, fewer decisions incorporate the above criteria better than choosing where to physically house and operate the business. Renting the right property and negotiating an airtight lease agreement are actions that serve as both a stabilizing force for a business and a hedge against uncertainty. However, as discussed in this article, when a business rents a property that is physically or legally deficient and without a proper agreement in place to disclaim financial or legal responsibility, it can jeopardize a business before it gets off the ground. This article serves as a wide-lens overview of the legal principle "*caveat emptor*", Latin for "buyer beware", in the American commercial leasing context while offering practical tips and considerations for businesses to consider. Since the scope and application of *caveat emptor* varies by state via case law and statute, this article serves as a general starting point.

CAVEAT EMPTOR, GENERALLY

Caveat emptor is a legal principle that shifts responsibility for examining a property before purchase to the buyer. In effect, the buyer "assumes the risk" of any defects or issues, known or unknown alike, unless the seller expressly claims responsibility or agrees to certain carveouts or conditions. The underlying rationale behind *caveat emptor* encourages that, when parties deal at arm's length, buyers are expected to practice due diligence under their own volition.



Historically, *caveat emptor* is rooted in sixteenth century English common law and applied to the sale of tangible goods (e.g., livestock, produce). However, by the early seventeenth century, the doctrine was also being applied to the purchase and sale of real property. Today, this principle has been substantially expanded and adapted to meet modern needs, particularly in consumer protection laws pertaining to leverage imbalances or fraud.

For our purposes, in the context of U.S. commercial leasing, the doctrine of *caveat emptor* means that tenants take the property as they find it and assume all risks associated with its condition, to the ultimate benefit of landlords. In other words, *caveat emptor* places responsibility on a tenant to thoroughly inspect the leased property before signing a lease agreement and, in the absence of a lease provision explicitly shifting legal or financial responsibility to Landlord (or a third-party) for repairing any problems identified with the property, means a tenant will be held liable for addressing those problems. This is the baseline, common law rule in practically every U.S. state, with the only consistent exceptions to its application being when a landlord either hides defects or intentionally misrepresents the condition of the property (a.k.a. fraud).

Although hidden or unknown defects are typically minor, i.e. when a door fails to lock or the HVAC system needs a tune-up, others can jeopardize the existence of a business.

As an illustrative example, in the Texas case *Denson v. Wilcox*, 298 S.W. 534, Tenant sued Landlord to recover compensatory damages caused by the toppling of a wall in a building occupied by Tenant's restaurant business. The jury found that (1) the wall fell due to poor initial construction of the building and (2) Tenant was not liable in any regard for the wall's deterioration and eventual collapse. Nonetheless, the court held that, under *caveat emptor*, Tenant took the property as they found it while assuming all risks incidental to the property's actual condition. In ruling for Landlord, the court further explained that (1) nothing verbally or in the lease agreement contained any warranty or representation by Landlord that the building was safe, (2) there was no covenant or agreement on Landlord's part to repair any issues with the property, and (3) that Landlord had no actual knowledge of the building's significant structural issues.

Similarly, in the Florida case *Haskell Co. v. Lane Co.*, 612 So. 2d 669, Tenant sued Landlord to recover damages incurred from the collapsed roof of a building used for Tenant's merchandising business. Tenant alleged that Landlord's contractor negligently constructed the building and that landlord itself negligently failed to disclose to Tenant that the roof drainage system was inadequate, "or to see that [the] inadequacies were corrected." At trial and on appeal, although it was undisput-

Studies have shown that intelligent people swear more than stupid motherfuckers.

ed that Tenant in no way contributed to the roof's collapse, the court ruled in favor of Landlord because (1) there was no express agreement between Tenant and Landlord assigning responsibility to landlord for any latent defects and (2) there was no evidence, nor was it ever plead, that Landlord misrepresented or otherwise intentionally concealed from Tenant any issues with the building's roof. Additionally, there was no evidence that Landlord knew or reasonably should have known about the roof issues.

On review of *Denson* and *Haskell Co.*, a reasonable business owner might question whether *caveat emptor* serves any purpose other than to foist springing burdens on unsuspecting tenants. The answer is decidedly no, given that front-end diligence is a common sense and critical act, particularly in transactions that consume a large portion of overhead costs. In practically every instance where a tenant is left "holding the bag" (so to speak) due to the manifestation of latent property defects, the tenant victim failed to properly inspect the property or, in the absence of an inspection, ensure an airtight lease agreement containing proper warranties, representations, and positive covenants by their landlord.

Of course, in many cases timing, cost concerns or disparities in bargaining power leave tenants little to no choice but to accept a premises on-sight or without securing a thoroughly protective lease. In any case, here are some concrete tips that prospective tenants can implement to eliminate the risk that latent property issues will gut their business.

1. PROPERTY INSPECTIONS

The first, most obvious step that a tenant should perform when weighing whether to rent a property is to inspect the property for any defects or issues that may affect their business operations. It's critical to inspect not only the visible aspects of the property (e.g., walls, floors, windows) but also systems such as plumbing, HVAC, electrical, roofing, and structural components. If the inspection identifies any defects or issues, this bolsters a tenant's leverage on important lease matters like rent, TI allowance, indemnity, etc. Inspection reports also serve as excellent backing for a tenant in the event that their landlord misrepresents the state of the property or asserts that a condition was known or obvious to the tenant at the time the lease was executed. Naturally, if a landlord refuses to humor any sort of inspection prior to signing of the lease, tread carefully.

2. REPRESENTATIONS, WARRANTIES, AND COVENANTS TO REPAIR

The ideal commercial lease agreement always contains representations and warranties as to the condition of the property, as well as covenants to repair on the part of Landlord. In the latter case, it is common for a Lease to partition responsibility for repairs between Landlord and Tenant, with Tenant generally responsible for maintenance of the inside of the premises, including systems like plumbing and HVAC, and Landlord generally responsible for structural elements like the roof, exterior walls, foundation, etc. Thus, when a landlord refuses to entertain any reps or warranties or capriciously disclaims responsibility for repairs, then the landlord typically (1) has substantially more bargaining power than a tenant, (2) lacks knowledge about the current or historical state of the property, and or (3) is double-dealing. In any event, and assuming there is no alternative option, it is critical that a tenant's initial property inspection is thorough, and that the lease's indemnity provision (if any) protects them from any legal or financial liability arising from defects that existed before the lease was signed.

Additionally, across several jurisdictions, landlords often must disclose known defects or conditions that may affect the safety, habitability, or use of the premises (e.g., mold, water damage, pest infestations, etc.). Although most of these laws apply exclusively in the residential context, tenants should still request a disclosure statement from the landlord that outlines any known issues with the property. If the jurisdiction doesn't require this, it's still beneficial for the tenant to ask the landlord to provide such a statement. A jurisdiction's health and safety code is a good initial resource to consult in this regard.

3. LEASE TERMINATION PROVISIONS

Of course, tenants should always strive to include a termination clause in their lease if possible. Many standard commercial leases do provide tenants with early termination rights, although these rights are usually limited to instances where a landlord has breached some nuanced, poorly defined lease obligation beyond any applicable notice and cure period. To this end, in instances where a property's condition is unknown or where Landlord refuses to entertain reps, warranties, or repairs, tenants should negotiate for the right to terminate the lease if defects cause the premises to be uninhabitable, in violation of applicable laws, or otherwise unfit for its intended purpose. In addition to any inspections, a property's construction, repair and maintenance history is a key resource to consult in this regard.

CAVEAT EMPTOR, IN CONCLUSION

Many consider *caveat emptor* an indifferent axe of public policy falling on unsuspecting buyers and tenants of real property. While consumer protection laws have largely lifted the specter of *caveat emptor* for residential tenancies and transactions involving tangible goods, it still retains its power over the U.S. commercial real estate industry. To this end, businesses must tread carefully when renting a location or negotiating lease terms. Although bargaining power, time, and cost concerns may prevent businesses from fully protecting themselves against a property's defects, the tips and guidance in this article will nonetheless assist commercial tenants in bolstering their bottom line.

1 Coke upon Littleton 102a (15th ed. London 1794) (1st ed. London 1628) ("Note, that by the civill law every man is bound to warrant the thing that he selleth or conveyeth, albeit there be no expresse warranty; but the common law bindeth him not, unlesse there be a warranty, either in deed or in law; for caveat emptor."). ■

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I used to be a banker, but then I lost interest.