Percentage Leases: Is There a Need to Imply a Covenant of Continuous Operation?

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PERCENTAGE LEASES: IS THERE A NEED TO IMPLY A COVENANT OF CONTINUOUS OPERATION?

I. INTRODUCTION

A percentage lease is one which contains a rental, paid by a commercial lessee, based upon a percentage of gross sales or receipts. This type of lease antedates this century, but did not become common until the Depression years. During this time, the unstable economy necessitated renegotiation of leases with a fixed rent. Today, prevailing social and economic factors have perpetuated the use of percentage leases.

1. Kline, Percentage Leases: May Lessee Vacate Premises?, 19 CLEV. ST. L. REV. 612, 612 (1970) (citing Friendly Center, Inc. v. Robinson, 233 F. Supp. 274 (D.N.C. 1954)); Hemingway, Selected Problems in Leases of Community and Regional Shopping Centers, 16 BAYLOR L. REV 1 (1964)). For example, a tenant who pays rent at $1000 per month and one-half percent on all gross sales over $1,000,000 is engaged in a percentage lease. The amount of percentage rent is commonly based on gross receipts, but can also be based on net receipts, gross profits, net profits, or any other variable that measures the tenant's business productivity. R. SCHOSHINSKI, AMERICAN LAW OF LANDLORD AND TENANT § 5.3, at 231 n.17 (1980). A percentage lease has also been defined as a lease “wherein the tenant is required to pay as rental a specified percentage of the gross income from the total sales made upon the premises.” S. McMICHAEL, LEASES — PERCENTAGE, SHORT AND LONG TERM 21 (4th ed. 1947).


3. 1 M. FRIEDMAN, supra, note 2, § 6.1.

Strangely enough, the percentage lease or percentage rental was first given widespread use in Depression days as a device for the protection of tenants. At that time, many merchants were weighed down by high rents and declining business. They sought some compromise in their lease agreements which might be based on business volume. Many owners agreed readily to this form [the percentage lease] of recasting the lease agreement because they viewed it as a necessary device to keep a good tenant in business.

S. McMICHAEL, LEASES — PERCENTAGE, SHORT AND LONG TERM 34 (5th ed. 1959). Moreover, most tenants were unable or unwilling to pay high fixed minimum rental during the Depression years. Accordingly, the percentage lease was of great benefit to the tenant. N. HECHT, LONG TERM LEASE PLANNING AND DRAFTING 77 (1974).

4. Thigpen, Good Faith Performance Under Percentage Leases, 51 MISS. L.J. 315, 315 (1980-81). Many of the prevailing social and economic factors result in advantages to both the landlord and the tenant. For a discussion of the percentage leases' advantages over the fixed rental lease, see 1 AMERICAN LAW OF PROPERTY § 3.66, at 320-25 (A. Casner ed. 1952); Denz, Percentage, Cost of Living and Revaluation Leases, 44 ILL. B.J. 312 (1956); Comment, The Lessee's Obligation Under a Percentage Lease, 60 NW. U.L. REV. 677 (1965); Note, The Percentage Lease — Its Functions and Drafting Problems, 61 HARV. L. REV. 317 (1947) [hereinafter Note, Drafting
The percentage lease creates a unique business relationship between the landlord and tenant. This business relationship is commonly known as a "quasi-partnership." As a result of this "quasi-partnership," the parties share in the success and failure of the business. For example, the landlord invests in the future of a tenant's business by foregoing a fixed minimum rental based on the fair market value of the property. While initial rent receipts may be low, the landlord receives a greater rental rate based on a percentage of the lessee's profits as the business becomes increasingly successful. In time, the rent received may surpass the fair market value of the property. Likewise, the tenant shares in the success and failure of the business by avoiding an initially high rental rate and then reinvesting any earned profits into the business with a goal of greater productivity in the future. Consequently, the percentage lease provides the tenant with a reasonable opportunity to establish a successful business. Once the business is

Problems]; Note, Resolving Disputes Under Percentage Leases, 51 MINN. L. REV. 1139 (1967) [hereinafter Note, Resolving Disputes].

With respect to the landlord, the percentage lease enables the landlord to achieve a fair rental on the value or productivity of property. See, e.g., Landis, Problems in Drafting Percentage Leases, 36 B.U.L. REV. 190 (1956). When a leased property becomes more valuable as a result of the tenant's efforts, the rent adjusts automatically. See Comment, supra. By attracting aggressive tenants who are willing to share the initial business risks, a landlord may receive more rental, through the percentage rent provision, as the business operation becomes increasingly successful. See Landis, supra. The obvious benefit to the tenant is that the rental expense can be "fixed" as an acceptable percentage of gross sales. This provides the tenant with the necessary flexibility and "cushion" in the early years of the tenant's business at the leased premises. Comment, supra, at 677. A percentage lease provides the tenant with more time to fully establish the business enterprise before the rental expense would approximate market value. Thereafter, as the business becomes more successful, the tenant has an ability to pay greater rental to the landlord.

5. Thigpen, supra note 4, at 326. Although the percentage lease does in fact create a quasi-partnership, some states have statutes which negate an inference of a partnership by reason of a landlord's receipt of rent based on the tenant's productivity in the property. See, e.g., UNIF. PARTNERSHIP ACT § 7(4)(b), 6 U.L.A. 39 (1969); WIS. STAT. § 178.04(3) (1987-88).

6. At a minimum, the percentage lease provides the tenant occupancy of the premises at a rent affordable during times of economic decline and provides the landlord with an opportunity to share in the tenant's success of the business without the negative aspect of a long-term rental. See Note, Drafting Problems, supra note 4. As an early example of this sharing agreement, English feudal lords required serfs to share an agreed upon percentage of cultivated crops. See Denz, Lease Provisions Designed to Meet Changing Economic Conditions, 1952 U. ILL. L.F. 344, 351.

7. Although the landlord foregoes a larger fixed minimum rental, the percentage lease alleviates problems of inflation. "Whenever inflationary conditions cause the current dollar receipts to fluctuate, the share of inflationary dollars payable to the lessor will vary proportionately." N. HECHT, supra note 3, at 77.

8. This is particularly important to both the landlord and tenant when a tenant with little or no experience is engaging in a new business venture, or the tenant is setting up shop in an area of economic decline with need of economic rehabilitation. Note, Drafting Problems, supra note 4, at 320.
successful, the tenant “shares” the success with the landlord by paying an increased rental. Thus, as one commentator has precisely stated:

Shared participation in the fruits of the demised premises is a central theme of percentage rental agreements. The landlord, by virtue of his agreement to accept a reduced return on his investment in times of business decline, is promised a percentage of profits or gross returns throughout the term of the lease. Thus, in a substantial sense, the lessor and lessee can be viewed as being in business together. They are partners, or at least quasi-partners, in a voluntary business association based on contract.9

However, this voluntary association based on a percentage lease is not without drawbacks. If the tenant does not put forth a “good faith” effort in operating the business,10 or prematurely vacates the premises,11 the landlord receives little or no rental. To avoid this problem, the percentage lease must be carefully drafted, setting forth the parties’ intentions with respect to operation of the business during the lease term. After all, it is the conduct of the tenant’s business that determines the “value” of the leased premises to the landlord. Unfortunately, all too often the lease agreement is not carefully drafted and it fails to define the parties’ rights and obligations. These poorly drafted lease agreements lead to conflicts, which in turn, lead to litigation. Indeed, one conflict which has been the subject of much litigation arises when a tenant prematurely vacates the premises.12

When the tenant prematurely vacates the premises, the landlord seeks judicial relief in order to protect his or her financial interest in the property. Generally, when the percentage lease does not expressly require a tenant to maintain operations for the duration of the lease term, judicial relief is sought in the form of an implied covenant of continuous operation. By implying a covenant of continuous operation, a court provides an appropriate remedy to the landlord for the breach thereof; to wit, the tenant must

9. Thigpen, supra note 4, at 326.
10. See Thigpen, supra note 4.
11. See, e.g., Kline, supra note 1, at 612.

There are several reasons why a percentage lessee might want to abandon the leased premises before the expiration of the lease. First, he may have a very successful venture and wants to increase its success by lessening or eliminating the percentage of his sales that must be paid to the lessor. Thus, he might abandon the premises in favor of a nearby location with a more economically favorable lease. Second, the lessee might be attempting to avoid a losing venture. His sales volume might be quite high which, of course, would entitle the lessor to a large percentage rent. But, the cost of operations might be so high that maintaining that level of sales would mean sustaining losses.

Id.

12. Note, Resolving Disputes, supra note 4, at 1144-46.
pay damages\textsuperscript{13} or render specific performance of the lease agreement,\textsuperscript{14} or the landlord is entitled to terminate the lease.\textsuperscript{15}

However, careful lease drafting or the availability of court remedies makes implying a covenant of continuous operation wholly unnecessary. Inconsistent results in the application of covenants of continuous operation, in order to provide landlords with a fair rental upon premature vacation of the premises, leads this commentator to believe that other remedial methods should be used to provide the landlord with the fair rental of the property. This Comment will discuss some of the problems that courts have faced when implying a covenant of continuous operation in a percentage lease. Section II explores the general provisions which courts interpret to determine whether to imply a covenant of continuous operation.\textsuperscript{16} Section III provides a presentation of the court's interpretive methods with respect to a covenant of continuous operation.\textsuperscript{17} Section IV addresses the issue of damages with respect to the implied covenant of continuous operation.\textsuperscript{18} Finally, Section V will conclude that there is no need to imply a covenant of continuous operation to provide the landlord with the fair rental value of the property.\textsuperscript{19}

II. DETERMINING THE EXISTENCE OF AN IMPLIED COVENANT OF CONTINUOUS OPERATION

A covenant is generally defined as a promise or agreement to engage or not to engage in some type of conduct.\textsuperscript{20} There are two types of covenants—express and implied.\textsuperscript{21} An express covenant is a promise or agreement explicitly stated within the terms of a lease.\textsuperscript{22} An implied covenant must be inferred from the terms of an agreement, to give full force and effect to the mutual intentions of each party.\textsuperscript{23} As a general rule, implied covenants are

\textsuperscript{13} See infra notes 111-22.
\textsuperscript{14} See infra notes 104-10.
\textsuperscript{15} This Comment will not discuss in any detail the landlord's remedy of terminating the lease.
\textsuperscript{16} See infra notes 20-83 and accompanying text.
\textsuperscript{17} See infra notes 84-100 and accompanying text.
\textsuperscript{18} See infra notes 101-43 and accompanying text.
\textsuperscript{19} See infra note 144 and accompanying text.
\textsuperscript{21} Covenants, supra note 20, § 11, at 583.
\textsuperscript{22} Id.; see, e.g., O'Sullivan v. Griffith, 153 Cal. 502, 506, 95 P. 873, 875 (1908); McDonough v. Martin, 88 Ga. 675, 677, 16 S.E. 59, 59 (1892).
\textsuperscript{23} Covenants, supra note 20, § 12, at 584.
not favored in law.\textsuperscript{24} This is a result of the general presumption that all promises or agreements are embodied within the terms of a contract.\textsuperscript{25} It does not necessarily follow, however, that a covenant will never be implied in a percentage lease.\textsuperscript{26}

The implication must arise from language used or it must be indispensable to effectuate [the] intention of parties; it must appear from language used that it was so clearly within contemplation of parties that they deemed it unnecessary to express it; implied covenants can only be justified on grounds of legal necessity; promise can be implied only where it can be rightfully assumed that it would have been made if attention had been called to it; there can be no implied covenant where [the] subject is completely covered by contract.\textsuperscript{27}

Starting with the premise that no express covenant of continuous operation exists, the specific legal issue confronted by a court in a percentage lease case is whether to imply a covenant of continuous operation to avoid depriving the landlord of his or her percentage rental.\textsuperscript{28} In determining whether to imply a covenant of continuous operation, courts attempt to give full force to the mutual intentions of each party.\textsuperscript{29} This requires an

An implied covenant is one which may reasonably be inferred from the whole agreement and the circumstances attending its execution. A covenant is viewed as implied in nature when its existence is inferred by legal construction from the use of certain words and phrases. There is no limitation upon the form or general character of the words which may lay the basis for the existence of an implied covenant; rather, the primary concern in this connection is the intention of the parties to the instrument.

\textit{Id.} (footnotes omitted); see also College Block v. Atlantic Richfield Co., 206 Cal. App. 3d 1376, 254 Cal. Rptr. 179 (Ct. App. 1988).


\textsuperscript{25} See Walgreen, 132 Ariz. at 515, 647 P.2d at 646; Mercury Inv. Co. v. F.W. Woolworth Co., 706 P.2d 523, 530 (Okla. 1985). As was stated in Walgreen:

\begin{quote}
This \textit{persona non grata} status is based primarily on the presumption that when parties have entered into written agreements which embody the obligations of each, they have expressed all of the conditions by which they intend to be bound and courts should be reluctant to enlarge, by implication, on those conditions which affect important matters.
\end{quote}


\textsuperscript{28} Kline, \textit{supra} note 1, at 613; Comment, \textit{supra} note 4, at 678-79. The issue exists solely because the percentage lease fails to adequately declare that the tenant is under an affirmative duty to operate the premises. 1 M. FRIEDMAN, \textit{supra} note 2, § 6.9, at 198.

\textsuperscript{29} Keystone, 459 N.E.2d at 422 (citing Leving v. Ponderosa Sys., 444 N.E.2d 896 (Ind. App. 1983)).
interpretation of the lease as a whole. Given the fact that the parties are "quasi-partners," one would think that a covenant to continually operate the premises is always a mutual intention of the parties. However, this is not the case, even though the fundamental principle behind a percentage lease is that the business must continually operate to be successful.

As this Comment will further illustrate, similar fact patterns often result in inconsistent conclusions of law. Nonetheless, since there is nothing unique in interpreting a percentage lease, the same rules of construction and interpretation that apply to contracts also apply to percentage leases. In determining the existence of an implied covenant of continuous operation, courts generally look at three provisions in the percentage lease: the rent percentage provision, the use clause, and the sublet or assignment clause.

A. The Rent Percentage Provision

The rent percentage provision is that clause in a lease which specifies the rent received by the landlord. The rental received is generally a combination of a fixed minimum rental rate and an additional rental based on a percentage of gross sales or receipts. However, there are also "pure" percentage leases. The implied covenant of continuous operation and the fixed minimum rental are essentially non-exclusive factors. Therefore, the
amount of fixed minimum rental is an important factor in determining whether to imply a covenant of continuous operation. In order to eliminate some of the confusion in interpreting this clause, courts essentially divide cases into two distinct categories. The first category involves a "pure" percentage rental, or nominal fixed minimum rental, while the second category involves a substantial fixed minimum rental.

Courts are generally consistent in implying a covenant of continuous operation when the rent percentage provision is "pure" or the fixed minimum rental is nominal. Likewise, courts are generally consistent in declining to imply a covenant of continuous operation when the fixed minimum rental is substantial. Unfortunately, determining whether the fixed minimum rental is either nominal or substantial is a precarious determination. Many factors must be considered. Such considerations include the duration of the lease, the amount of fixed minimum rental paid in relation to the established fair market value of the property, whether the tenant has ever paid an additional percentage rental and if so, how much and how often, and the type of business of the tenant. However, it should be noted that some courts hold that the amount of fixed minimum rental is immaterial in determining whether to imply a covenant of continuous operation.

1. "Pure" Percentage Leases and the Nominal Fixed Minimum Rental

A "pure" percentage lease is one in which no fixed minimum rental is set; the landlord's return on the value of the leased premises depends entirely upon the efforts and productivity of the tenant. If the tenant produces no income, the landlord receives no rent. A nominal fixed minimum rental percentage lease is one which provides for an inadequate minimum

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41. Kline, supra note 1, at 612.
42. See infra notes 47-51 and accompanying text.
43. See infra notes 52-54 and accompanying text.
46. See, e.g., Walgreen, 132 Ariz. at 512, 647 P.2d at 643; Downtown Ass'n, 34 Ohio App. 3d at 296, 518 N.E.2d at 564.
rental that is payable, regardless of the tenant's success in the business, and an additional rental based on a percentage of gross sales or receipts.\textsuperscript{48}

As previously stated, courts are generally consistent in implying a covenant of continuous operation with these types of leases.\textsuperscript{49} The general rationale is that when a percentage lease is "pure," or contains only a nominal fixed minimum rental, the rent percentage provision of the lease is intended to provide the major portion of the rent.\textsuperscript{50} It is therefore unacceptable to allow a tenant to vacate the premises and stop paying rent, or pay only the nominal fixed rental.\textsuperscript{51}

2. Substantial Fixed Minimum Rental Percentage Leases

A substantial fixed minimum rental percentage lease is one which provides for a \textit{substantial} or \textit{adequate} minimum rental, that is payable regardless of the tenant's success in the business, and an additional "bonus" or "windfall" based on a percentage of gross sales or receipts.\textsuperscript{52} Previously, most courts held that a percentage lease which contained, in the absence of an express provision in the lease, a substantial fixed minimum rental did not obligate the tenant to continually operate the business on the premises.\textsuperscript{53} However, to make the issue more complex, courts presently look more closely at the circumstances surrounding the execution of a lease in order to determine whether the parties considered the minimum rental as an adequate return to the landlord.\textsuperscript{54}

\textbf{B. The Use Clause in Percentage Leases}

Landlords often argue that use clauses prevent the tenant from abandoning the premises before the expiration of the lease.\textsuperscript{55} While this argu-

\textsuperscript{48} Lippman, 44 Cal. 2d at 136, 280 P.2d at 775; Stockton Dry Goods Co. v. Girsh, 36 Cal. 2d 677, 227 P.2d 1 (1951).

\textsuperscript{49} See supra note 44 and accompanying text.

\textsuperscript{50} Kline, supra note 1, at 612.

\textsuperscript{51} Id. (citing ABA Comm. on Leases, \textit{Drafting Shopping Center Leases}, 2 \textit{REAL PROP., PROB., AND TRUST J.} 222 (1967)).


\textsuperscript{53} Note, \textit{Resolving Disputes}, supra note 4, at 1144-45.


\textsuperscript{55} 1 M. Friedman, supra note 2, § 6.904, at 207. Generally, use clauses are phrased as follows: The tenant "will use the premises for —" \textit{Id.} at 207-08.
ment appears strong, it has had little success.\textsuperscript{56} Consistent with the general proposition that a tenant may use the leased premises for any lawful purpose, absent a valid restriction, courts generally hold that a tenant is not obligated to operate a particular business on the leased premises.\textsuperscript{57} For example, in \textit{Rapids Associates v. Shopko Stores},\textsuperscript{58} the Wisconsin Court of Appeals held that a use clause does not require a tenant to continually operate on the premises.\textsuperscript{59} Thus, "absent a clear and specific indication that the landlord intended to limit the tenant’s use of the property,"\textsuperscript{60} a use clause is permissive and not restrictive in nature.\textsuperscript{61} Accordingly, no implied covenant of continuous operation will be found solely as a result of a use clause being contained in the percentage lease.

Perhaps the most compelling case which denied implying a covenant of continuous operation on the basis of a use clause is \textit{Weil v. Ann Lewis Shops}.\textsuperscript{62} In \textit{Weil}, the lease contained a percentage rent provision and a use clause. The premises were to be occupied and used for conducting a women’s and children’s retail store “‘and not otherwise.’”\textsuperscript{63} When the tenant failed to take occupancy of the premises, the landlord sued and was denied

\begin{itemize}
  \item \textsuperscript{56} Id. at 207.
  \item \textsuperscript{58} 96 Wis. 2d 516, 292 N.W.2d 668 ( Ct. App. 1980).
  \item \textsuperscript{59} Id. at 519, 292 N.W.2d at 670. It is interesting to note that in Wisconsin a covenant of continuous operation will probably never be implied. The \textit{Rapids} decision pointed out that covenants to restrict the use of demised premises must be expressly set forth in a lease and may not be implied; this as a result of § 235.02 of the Wisconsin Statutes. \textit{See} \textit{Wis. STAT.} § 235.02 (1969), \textit{renumbered} \textit{Wis. STAT.} § 706.10(6) (1987-88). Moreover, long term leases such as a percentage lease are deemed a conveyance in Wisconsin and no covenant shall be implied in any conveyance. \textit{Wis. STAT.} § 706.10(6) (1987-88). Accordingly, a landlord must seek some remedy other than an implied covenant of continuous operation to protect the financial interest in his or her property.
  \item \textsuperscript{60} Forman v. United States, 767 F.2d 875, 880 (Fed. Cir. 1985).
  \item \textsuperscript{62} 281 S.W.2d 651 (Tex. Ct. App. 1955).
  \item \textsuperscript{63} Id. at 653 (quoting the lease agreement).
any recovery of percentage rental at the trial court level. The issue on appeal was whether the lease expressly, or by necessary implication, provided that the tenant would occupy and use the premises for the purposes stated in the lease. The Texas Court of Civil Appeals found that use clauses have never been held to be an agreement to continually occupy and use the demised premises. Accordingly, no implied covenant of continuous operation was found.

However, there are courts which have held that a use clause is indicative of a covenant of continuous operation. Nonetheless, many courts construe even very strong "use provisions" as only restricting the use of the property, and not as mandating that the property be used in fact. The rationale for this ruling is that lease agreements are construed in favor of the tenant and against the landlord. If it is clear from the lease as a whole, the courts will imply a covenant of continuous operation. An implied covenant of continuous operation, however, is rarely found and is clearly the minority view. Thus, as a general statement of the law, a use

64. Id. The tenant paid the fixed minimum rental of $650 per month for 13 months. The premises, however, lay dormant for 23 months. The jury returned a verdict for the plaintiff and awarded $16,295 in damages. However, the trial court granted the defendant's motion for judgment notwithstanding the verdict. Id.

65. Id.

66. Id. at 654. In Dickey, the court stated:

Generally speaking, a provision in a lease that the premises are to be used only for a certain prescribed purpose imports no obligation on the part of the [tenant] to use or continue to use the premises for that purpose; such a provision is a covenant against a noncomplying use, not a covenant to use.


67. Weil, 281 S.W.2d at 656.

68. See, e.g., Emro Marketing Co., 855 F.2d 528; Simhawk Corp. v. Egler, 52 Ill. App. 2d 449, 202 N.E.2d 49 (App. Ct. 1964) (use clause provided that tenant should only use premises for operation of shoe store); Fox v. Fox Valley Trotting Club, 8 Ill. 2d 571, 134 N.E.2d 806 (1956) (use clause provided that tenant should use premises solely for staging harness races); Ingnamorte v. Kings Super Markets, 5 N.J. 223, 260 A.2d 841 (1970); Slater, 376 Pa. Super. 580, 546 A.2d 676; Ayres Jewelry Co. v. O & S Bldg., 419 P.2d 628 (Wyo. 1966) (premises to be used for jewelry shop).

69. See, e.g., Congressional Amusement Corp. v. Weltman, 55 A.2d 95 (D.C. Cir. 1947) (premises to be used for sale of alcoholic beverages and other associated items for "off sale" consumption and no other purposes); Davis v. Wickline, 205 Va. 166, 135 S.E.2d 812 (1964) (premises to be used for drug store and no other purpose).

70. Forman, 767 F.2d at 880. "Because the [tenant] stands in the position of an owner in fee with regard to rights of user ... covenants restricting the [tenant's] right of use are strictly construed against the landlord where there is any ambiguity." 1 AMERICAN LAW OF PROPERTY § 3.40, at 254 (A. Casner ed. 1952).

71. See, e.g., Stern v. Dunlap Co., 228 F.2d 939 (10th Cir. 1955).
clause, standing alone, has little chance of imposing an implied covenant of continuous operation.

C. Subleasing and Assigning in Percentage Leases

Like the use clause, a sublease or assignment clause may play an important role in a court’s determination of whether to imply a covenant of continuous operation in a percentage lease. Essentially, if there is an express right to sublease the premises or assign the lease in a percentage lease, courts will not imply a covenant of continuous operation. Courts base this determination on the inconsistency between the lease permitting the tenant to sublease or assign, and implying an obligation on the tenant to remain on the premises and conduct business.

Sometimes a landlord will argue that a different business operation on the premises will severely curtail his or her ability to secure a percentage rental. This argument has met with some success. Generally, however, unless a sublease or an assignment clause requires the landlord’s prior consent, courts have little difficulty in allowing any legitimate business enterprise to operate on the premises as a subtenant. For example, in *Carter v. Safeway Stores,* Carter brought an action against Safeway for, among other things, a breach of an implied covenant of continuous operation. Pursuant to the assignment and sublease clause in the lease, Safeway assigned the premises to a clothing store. Carter argued that since the rent percentage provision was based on gross sales, and a clothing store has a much lower volume of business than that of a grocery store, the court should imply a covenant of continuous operation. The court declined and held

72. 1 M. FRIEDMAN, supra note 2, § 6.903, at 206.
76. See, e.g., John Hogan Enter., Inc. v. Kellogg, 187 Cal. App. 3d 589, 231 Cal. Rptr. 711 (Ct. App. 1986) (proposed assignee admitted they would never generate gross sales sufficient to produce rental income equivalent to that being paid by tenant).
that because nothing in the assignment or sublet clause required Carter's consent, Safeway was free to assign its lease to any retail store.\textsuperscript{79}

Landlords may prevent such harsh results, as exemplified in \textit{Carter}, and protect their interest in the percentage rental income by inserting specific provisions in the percentage lease. For example, if the tenant’s right to sublease or assign is unrestrained, the landlord’s interest will usually be protected when a provision providing that an average of previous rental payments becomes the fixed minimum rental upon assignment or sublease.\textsuperscript{80} Another way for landlords to protect their interest is to require the tenant to obtain consent for any potential assignee or subtenant. Courts have held that when consent is required, the landlord’s refusal of a subtenant who is incapable of reaching the required percentage rental level is not unreasonable.\textsuperscript{81} For example, in \textit{John Hogan Enterprises v. Kellogg},\textsuperscript{82} the California Court of Appeals held that it was not commercially unreasonable for a lessor to withhold consent where a proposed assignee admitted that they would never generate gross sales sufficient to produce rental income equivalent to that being paid by the lessee.\textsuperscript{83} Thus, while a sublease or assignment clause may prevent an implied covenant of continuous operation, landlords may still protect their interest in the percentage rent. Therefore, any need to imply a covenant of continuous operation is clearly diminished since the landlord’s goal in seeking an implied covenant of continuous operation is generally to protect the landlord’s interest in the property.

\section*{III. \hspace{1em} Interpretive Methods}

As stated throughout this Comment, a covenant of continuous operation generally will not be implied to protect the landlord’s interest in the property but will allow the landlord to receive that for which he originally bargained. Originally, courts strictly construed the percentage lease, whereas now they look more closely at the intentions of each party.

\textsuperscript{79} \textit{Id.} at 548, 744 P.2d at 60; see also \textit{Williams}, 198 Kan. at 331, 424 P.2d at 541.


\textsuperscript{81} \textit{Jones}, 35 N.C. App. at 170, 241 S.E.2d at 140.

\textsuperscript{82} 187 Cal. App. 3d at 589, 231 Cal. Rptr. 711 (Ct. App. 1986).

\textsuperscript{83} \textit{Id.} at 589, 231 Cal. Rptr. at 711.
A. The Substantial Minimum Rental Doctrine

A test which was frequently used by courts in determining whether to apply a covenant of continuous operation is the substantial minimum rental doctrine. This doctrine requires that the stipulated minimum rental must not constitute substantial consideration. Essentially this doctrine requires a determination of whether the fixed minimum rental is either nominal or substantial. The birth of the substantial minimum rental doctrine occurred in Jenkins v. Rose's 5, 10 & 25¢ Stores. In Jenkins, the lease provided for a guaranteed minimum rental of $2400 per year and five percent of the tenant's annual gross sales. The tenant vacated the premises prior to the expiration of the term but continued paying the minimum rental of $2,400 for the year. Thereafter, the landlords sought to recover an additional rent under the percentage rental provision. The court held that since the lease failed to show any stipulated agreement requiring the tenant to operate a store on the demised premises, and the landlords protected their interest by requiring a fixed minimum rental, the $2400 paid by the tenant was in full settlement of the rent due.

The Jenkins decision expressed a clear standard to determine whether to imply a covenant of continuous operation. If the fixed minimum rental is substantial, then an implied covenant of continuous operation will not be found, and the tenant's payment of the fixed minimum rental to the landlord is sufficient. Conversely, if the fixed minimum rental is "nominal," an implied covenant of continuous operation will be found. Courts generally follow the substantial minimum rental doctrine in their interpretation of a percentage lease (although it is clearly not the only factor) and will not imply a covenant of continuous operation when the fixed minimum rental is substantial. However, the Illinois Court of Appeals in Harvey v. Rolands of Bloomington, Inc., stated that a literal or strict construction of a per-

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84. Accordingly, if the fixed minimum rental is substantial, no covenant will be implied; however, if the fixed minimum rental is not substantial, a covenant will be implied. Note, Resolving Disputes, supra note 4, at 680.
85. 213 N.C. 606, 197 S.E. 174 (1938).
86. Id. at 608, 197 S.E. at 175.
87. Id.
88. Id. The court strongly emphasized the fact that the lease contained no clause requiring the tenant to operate on the premises. This is the essence of strict interpretation; if a clause does not mandate specific conduct, that conduct will not be enforced.
89. Id.
90. See supra notes 52-54 and accompanying text.
centage lease must give way to the purposes intended by the parties. This was a new development in the interpretation of the percentage lease, and it continues today.

B. Intent Test

Courts today look more closely to the intent of each party when determining whether to imply a covenant of continuous operation. For example, in Taylor v. Universal Tire, Inc., the court held that the relation of minimum fixed rental to total rent was not determinative in deciding whether to apply a covenant of continuous operation.

The intent test involves looking at all relevant factors surrounding the execution of a percentage lease. Considering that these factors may be varied, it is easy to understand why the courts are inconsistent in their reasoning and results. Robert Schoshinski has illustrated the factors and the resulting inconsistency:

The fact that extensive repairs or improvements have been made by the lessor in anticipation of increased sales and therefore increased rent under the percentage formula has been weighed in favor of implying a covenant of continued use. Evidence of prior dealings between the parties may indicate that full and continued use of the premises throughout the term was within the expectation of the par-

92. Id. at 449, 237 N.E.2d at 544. The court in Harvey reasoned that the real intention of the parties is what controls, and not some particular word or phrase. Accordingly, the court noted that searching out obscure possibilities in simple words should not be done if the party's purpose then becomes distorted. Id. Although the Harvey court was determining rent due under a percentage lease, other courts also used an intent test to determine whether a covenant of continuous operation should be implied. For cases illustrating a timeline of the court's interpretive methods, see Kline, supra note 1, at 616-18.

93. One commentator provides:

Some recent decisions . . . indicate that the courts are becoming more willing to closely examine the circumstances surrounding execution of the lease in an effort to determine whether the parties themselves considered the substantial minimum rent to be an adequate return to the lessor. This trend is occurring concurrently with changes which are taking place in the circumstances surrounding store leases. Most new store construction today is taking place in the form of shopping centers, and, the percentage lease is the rule, rather than the exception, in the modern shopping center lease. The exact percentage is negotiated between lessor and lessee with as much importance as the minimum rental. The percentage rental has become something other than a "mere windfall," and, in fact, has become almost as much the substance of the lease as the minimum rental. Therefore, this trend in the courts today is a realistic appraisal by the courts of the context in which the modern percentage lease is negotiated.

Kline, supra note 1, at 613 (footnotes omitted).

94. 672 S.W.2d 775 (Tenn. Ct. App. 1984).

95. Id. at 779.

ties at the commencement of the lease. And it has been suggested that, even if a minimum rent is substantial, a tenant would not be justified in discontinuing operations "for spite or to inflict harm."

Conversely, factors which have been noted or apparently considered in decisions which refused to imply a duty of continued use include these situations: the lease was for the operation of a new business and thus percentage rent was not heavily relied on; an express covenant of continuous operation was not included in a lease which was quite lengthy, contained numerous provisions covering many contingencies, and was entered into only after prolonged negotiations; the lease authorized the tenant to remove his personal property or fixtures from the premises during the term of the lease; other leases by the same landlord contained an express covenant to use leased premises; the lease contained an express provision against competition by the lessor but not by the lessee.97

To avoid interpretation problems, the California Court of Appeals, in *Cousins Investment Co. v. Hastings Clothing Co.*,98 established five rules for implying covenants:

(1) The implication must rise from the language used or it must be indispensable to effectuate the intention of the parties;

(2) it must appear from the language used that it was so clearly within the contemplation of the parties that they deemed it unnecessary to express it;

(3) implied covenants can only be justified on the grounds of legal necessity;

(4) a promise can be implied only where it can be rightfully assumed that it would have been made if attention would have been called to it; [and]

(5) there can be no implied covenant where the subject is completely covered by the contract.99

These rules have, for some reason, never been fully adopted by the courts.100 They appear to be useful guidelines that would lend assistance to the courts in their determination of whether or not to imply a covenant of continuous operation. However, assuming that an interpretation of the parties' intent in a lease is difficult, as inconsistent rulings illustrate, perhaps

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98. 45 Cal. App. 2d 141, 113 P.2d 878 (1941).
99. Id. at 149, 113 P.2d at 882.
100. These five rules are often used by courts, but not consistently. Much of the courts' confusion lies in the failure to establish succinct rules for implying a covenant of continuous operation. Given the fact that *Cousins* fully establishes a guideline, it is difficult to understand why all jurisdictions have not adopted these guidelines.
courts should use other methods to protect a landlord's financial interest in property under a percentage lease.

IV. REMEDIES UPON TENANT'S VACATION OF THE PREMISES

Although there are cases to the contrary, if a tenant breaches a covenant of continuous operation in a fixed rental lease, courts will permit the landlord to recover the stipulated rental. However, when a percentage lease is involved, courts encounter a difficult problem when a tenant breaches a covenant of continuous operation. When the breach occurs, courts must provide the landlord with an adequate remedy. Generally, this remedy is in the form of either specific performance or the recovery of damages. Unfortunately, these remedies are usually inadequate relief for the landlord.

A. Specific Performance

Specific performance is primarily used as a remedy when an "anchor" tenant in a shopping center prematurely vacates the premises. With respect to the "anchor" tenant, there is great difficulty in estimating the loss of percentage rent upon premature vacation. Also, a large vacant store in a shopping center will presumably project an image for the shopping center of financial instability. This "image" could result in lost patronage, and thus, even greater financial losses to the landlord. Accordingly, specific performance may be the only adequate remedy available to guard against such potential losses. By requiring the tenant to remain on the premises and operate the business, the landlord then has the opportu-

102. Id. at 238-41; see also Note, Specific Performance of Shopping Center Leases in California, 21 Hastings L.J. 532 (1970) [hereinafter Note, Specific Performance]; Note, Damages: Implied Covenants in Percentage Leases, 12 Okla. L. Rev. 293 (1959) [hereinafter Note, Damages].
103. R. Schoshinski, supra note 1, § 5.5, at 238-41.
104. See Note, Specific Performance, supra note 102, at 535-37. The success of the shopping center, and the business therein, depends on the landlord's ability to specifically enforce a tenant's covenant to remain in business. This is especially true where an "anchor" tenant ceases operations on the demised property. When an "anchor" tenant prematurely vacates the premises, the landlord and other shopping center tenants are deprived "of a business that was deliberately included . . . to increase [the shopping center's] chances of success." Id. at 536.
105. Id.
107. Id.
108. See Note, Specific Performance, supra note 102, at 537; see also Lincoln Tower Corp. v. Richter's Jewelry Co., 152 Fla. 542, 12 So. 2d 452 (1943); Dover Shopping Center, Inc. v. Cushman's Sons, Inc., 63 N.J. Super. 384, 164 A.2d 785 (1960).
nity to receive his anticipated rental income. However, courts are reluctant to use specific performance as a remedy, and when it is issued, it often does not provide adequate relief to the landlord. Moreover, specific performance runs contrary to the doctrine of free alienability of property. The tenant should be allowed to vacate the premises as long as appropriate damages are paid to the landlord. While the remedy of specific performance may be essential to the survival of a large shopping mall, it seems unwarranted for non-shopping mall tenants.

B. Assessing Damages

Assessing damages is often a major concern of the courts. As previously noted, when there is no fixed minimum rental, or the fixed minimum rental is nominal, courts will usually imply a covenant of continuous operation. However, when the fixed rental is substantial, the tenant is often required to pay, as damages, only the fixed minimum amount. For example, in Kroger Co. v. Bonny Corp., a percentage lease had been in effect for about thirteen years at the time of the alleged breach. During the first twelve years, annual sales were insufficient to invoke the percentage rent clause. In the thirteenth year, however, increased sales resulted in an additional payment of percentage rent above the fixed minimum rental. When the tenant prematurely vacated the premises, the court determined that since the tenant operated the premises for thirteen years, and only reached the percentage rental level during one of those years, the percentage rental was a bonus and not really contemplated by the parties to be a portion of the rent. Thus, only the fixed minimum rental was awarded as damages.

111. See Note, Damages, supra note 102. Damages are extremely difficult to calculate, since future sales must be estimated to determine the percentage rent for which the tenant is liable.
112. See supra notes 44, 47-54 and accompanying text.
113. See supra notes 52-54 and accompanying text.
115. The lease provides for minimum monthly payments of $2253 per month plus a percentage of sales in excess of $2,704,000 per year. Id. at 835, 216 S.E.2d at 345.
116. Id. at 836, 216 S.E.2d at 345.
117. Id. at 840, 216 S.E.2d at 344.
The decision in *Kroger* appeared to be a simple matter. Because the tenant's yearly sales were insufficient to meet the percentage rent level, the court determined that the fixed minimum rent was substantial. Therefore, only that amount was awarded as damages. However, courts sometimes only award the fixed minimum rent as damages even when the tenant is paying a greater amount based on the percentage rental provision. For example, in *Monte Corp. v. Stephens*, the court held that the tenant would only be required to pay the fixed minimum rental, even though the tenant previously paid percentage rental above and beyond that amount.

These two cases illustrate the court's inability to establish clear guidelines when assessing damages. Indeed, problems of assessing damages intensify when the tenant's operation is new or occupancy is very brief. In these instances, there is no standard which courts may use to determine damages. Thus, to make matters easier, courts often measure damages by the fair rental value of the property. It is this Commentator's opinion that the fair rental value method could be used in every case, obviating the need to imply a covenant of continuous operation.

C. Bastian v. Albertson's, Inc.: The Implied Convenant to Pay Reasonable Rent

The Idaho Court of Appeals, in *Bastian v. Albertson's, Inc.*, made a significant impact on the interpretation of percentage leases when it implied a covenant to pay reasonable rent. Although the facts in *Bastian* are easily distinguishable, the decision does provide a unique and useful way to interpret the percentage rent provision.

1. Facts

In *Bastian*, the landlord leased property to the tenant for use as a grocery store in 1948. After the leased building was destroyed by fire in 1961, the parties entered into extensive renegotiation of the existing lease, which

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118. *Id.* Although, the Georgia Court of Appeals also considered that the lease was assignable in its decision, the greatest emphasis in the decision was placed on the substantiality of the fixed minimum rental. *Id.*


120. *Id.* at 539. The rent percentage provision provided for $200 per month or seven percent of gross sales. For two years the tenant paid over $400 per month before prematurely vacating the premises. *Id.*

121. Sinclair Refining Co. v. Davis, 47 Ga. App. 601, 171 S.E. 150 (1933) (damages measured by the fair rental value of premises when no other adequate basis exists).

122. *Id.*

123. 102 Idaho 909, 643 P.2d 1079 (Ct. App. 1982).

124. *Id.*
did not expire until 1968. As a compromise, the parties "hammered out" a new lease agreement.\textsuperscript{125} This agreement gave the landlord a flat $1000 monthly rental until 1968. The lease also provided the tenant with a right to renew the lease for an additional ten-year period after 1968, for $1000 per month or a percentage of gross sales, whichever was greater.

The lease was renewed for the ten-year period in 1968. However, in 1976, the tenant ceased operating the grocery store and opened a new store nearby.\textsuperscript{126} The tenant had an express right, under the lease agreement, to assign the lease or sublet the property. The tenant never did. Instead, the tenant maintained possession of the property throughout the remaining period of the lease, paying the landlord the minimum rental of $1000 per month. Before the expiration of the lease, the landlord sued to enjoin the tenant from ceasing its business operations on the demised premises, claiming that the lease contained an implied covenant of continuous operation.

A bifurcated trial was held to determine liability and damages on the claimed breach of the lease. The trial court held that although there was no implied covenant of continuous operation, the lease agreement did contain an implied covenant to pay reasonable and adequate rent for the property should the tenant discontinue business, but not to assign or sublet the property.\textsuperscript{127}

2. The Majority Opinion

On appeal, the Idaho Court of Appeals addressed two significant issues: (1) whether the trial court erred in failing to find an implied covenant of continuous operation,\textsuperscript{128} and (2) whether the trial court erred in determining that there was an implied covenant to pay reasonable and adequate rent.\textsuperscript{129} With respect to the implied covenant of continuous operation, the court of appeals affirmed the trial court's holding that a covenant could not be found.\textsuperscript{130} The court had little difficulty in making this decision and simply followed the general rule that when the tenant is granted an unre-

\textsuperscript{125} Id. at 910, 643 P.2d at 1080. In addition to agreeing on the rental, both parties agreed to contribute to the cost of a new building. The landlord contributed $90,000 while the tenant contributed between $50,000 and $60,000. Id.

\textsuperscript{126} Id. Immediately prior to vacating the premises, the tenant removed fixtures and shelving from the premises pursuant to an express right. Id.

\textsuperscript{127} Id. at 911, 643 P.2d at 1081.

\textsuperscript{128} Id.

\textsuperscript{129} Id. There was also another issue concerning attorneys' fees, however it is not significant for the purposes of this discussion. Id. at 915, 643 P.2d at 1085.

\textsuperscript{130} Id. at 912, 643 P.2d at 1084.
strained right to assign or sublease the premises, it is inconsistent to imply a
covenant of continuous operation.131

The court of appeals fully accepted the trial court's decision to imply a
covenant to pay reasonable rent. The trial court found that the parties
failed to explicitly state in the lease what the rental would be if the tenant
stopped using the premises. Although there was a provision relating to the
payment of rent by the tenant upon assignment or sublease, this provision
was silent on rental if the tenant elected not to assign the lease or sublet the
property. Thus, as a result of deeming the flat $1000 monthly rental inade-
quate, the trial court implied a covenant to pay reasonable rent.132

Then, the Idaho Court of Appeals noted the factual similarities of Lipp-
man v. Sears Roebuck & Co.133 as a basis for its affirmation and stated:

Since the parties had made specific provisions in the Lippman
lease that the rental (or damages) would be the average of the pre-
ceding twelve months rental in the event lessee assigned or subleased
or abandoned the premises, the California Supreme Court agreed
this was a proper measure of damages to apply where Sears had
abandoned "the integral purpose for which the lease was made."134

Unlike Lippman, however, the landlord in Bastian failed to set forth any
guidelines for determining an adequate rental upon assignment or sublease.
The court of appeals had no standard by which to assess damages. Accord-
ingly, the court implied a covenant to pay reasonable and adequate rent to
fill "the void left by the parties as to what was to occur if the [tenant] quit
its sales operation; yet did not assign or sublet."135

Finally, the court of appeals affirmed the trial court's determination that
the landlord was entitled to damages in the amount of the fair rental value
of the property. The court of appeals noted that:

In arriving at the fair rental value, the trial court considered several
factors — the value of the property from the perspective of a hypo-
thetical new lessee, the past rental history of the property, the cir-
cumstances of the parties in the leasing of the property, and a fair
return on the lessors' investment in the property.136

131. For cases following the general rule that it is inconsistent to imply a covenant of contin-
uous operation when an express right to sublease or assign exists, see cases cited supra note 73.
134. Bastian, 102 Idaho at 913, 643 P.2d at 1083.
135. Id. at 914, 643 P.2d at 1084.
136. Id. at 915, 643 P.2d at 1085.
Thus, the Idaho Court of Appeals concluded that there was substantial and competent evidence to support the trial court's finding of a reasonable rent, and did not disturb the decision on appeal.

3. Critique

In *Bastian v. Albertson's, Inc.*, the Idaho Court of Appeals broke new ground in interpreting percentage leases. Never before — and unfortunately not since — has a court implied a covenant to pay reasonable rent after failing to imply a covenant of continuous operation. This decision is significant because it gave the tenant an opportunity to vacate the premises, while it enabled the landlord to receive the fair rental value of the demised property. Accordingly, both parties' problems and concerns were sufficiently addressed. This resolution was successful due to the implied covenant to pay reasonable rent.

As a result of conflicting provisions in the percentage lease, the Idaho Court of Appeals was confronted with a dilemma. On the one hand, the court deemed the fixed minimum rental inadequate compensation for the value of the property. This, in essence, mandated finding an implied covenant of continuous operation. On the other hand, however, there existed a right on the part of the tenant to assign the lease or sublet the property. This, in essence, mandated not implying a covenant of continuous operation. Either way, the court would have contradicted well-established majority law.

For example, if the court had implied a covenant of continuous operation, the result would have been inconsistent with the majority view that an implied covenant of continuous operation will not be found when there is a right of the tenant to assign or sublease. Also, if the court did not find an implied covenant of continuous operation, the landlord would only be provided with nominal rent. This too would be inconsistent with the majority view. Thus, the court addressed both of these problems by denying an implied covenant of continuous operation, yet finding an implied covenant to pay reasonable rent.

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137. 102 Idaho 909, 643 P.2d 1079 (Ct. App. 1982).
139. *See supra* notes 38-54 and accompanying text.
140. *See supra* notes 72-83 and accompanying text.
141. *Id.*
142. *See supra* notes 38-54 and accompanying text.
Obviously, this conflict does not occur only when dealing with a fixed rental lease. Absent an express provision to the contrary, the tenant could vacate the premises and simply pay the fixed rental. When dealing with a percentage lease, however, courts are concerned with providing reasonable and adequate rental to the landlord. This is why landlords argue for an implied covenant of continuous operation.

In Bastian, however, the court did not need to imply a covenant of continuous operation to give the landlord an opportunity to receive the reasonable value of the property. This was accomplished by implying a covenant to pay reasonable rent. This leads to the question of whether implying a covenant of continuous operation is really necessary to provide relief to the landlord. Unfortunately, the Bastian court did not address this question. The court did, however, establish an effective method to circumvent the problems in implying a covenant of continuous operation, when it implied a covenant to pay reasonable rent. Perhaps now courts may begin to imply a covenant to pay reasonable rent, rather than imply a covenant of continuous operation.

V. Conclusion

The foregoing discussion illustrates that courts have difficulty in determining whether to imply covenants of continuous operation in percentage leases. However, in light of Bastian v. Albertson’s, Inc., and other practical approaches, it appears possible to eliminate the interpretation problem altogether. As previously stated throughout this Comment, the main purpose in implying a covenant of continuous operation in a percentage lease is to protect the landlord’s financial interest in the value of his property when a tenant prematurely vacates the premises. Although an implied covenant of continuous operation may still be necessary if a landlord seeks termination of a lease or seeks specific performance of an “anchor” tenant in a shopping mall, it appears wholly unnecessary if the landlord is simply attempting to protect his financial interest in a property.

Careful lease drafting usually eliminates the need to imply covenants of continuous operation. Inserting an express covenant of continuous operation or a liquidated damages clause will eliminate most problems. Moreover, the lease can also include a provision whereby the tenant pays the fair market value of the property for the duration of the lease if the tenant prematurely vacates the premises. Alternatively, the landlord could seek a judicial determination of the fair market value as was illustrated in Bastian.

143. See generally R. Schoshinski, supra note 1, § 5.1, at 227.
144. 102 Idaho 909, 643 P.2d 1079 (Ct. App. 1982).
Pursuant to *Bastian*, courts may now begin to imply covenants to pay reasonable rent, rather than implying a covenant of continuous operation. Essentially, the ultimate effect is the same. Overall, the implied covenant of continuous operation still has its use, but if the landlord is merely seeking to protect a financial interest in property, other approaches are more appropriate.

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