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Understanding the Legal Concept of Material Breach in a Tightening Economy

If you've seen it once in a deal, you've seen it hundreds of times. Landlords, tenants, buyers, sellers, brokers and bankers either demand or reject its presence within the fine print of a deal. However, the question remains, what exactly does the term "material breach" mean? As a practicing commercial real estate attorney, I've been asked this question many times by my clients and opposing attorneys alike. However, it's hard to just open up the dictionary and give the term a flat definition. Why? Well, the term is more than just a word in need of a definition. It's a legal concept which, like any legal concept, requires the application of a set of legal tests and factors to a set of facts which enable one to arrive at a meaningful analysis. However, the purpose of this article is not to give a full, legal dissertation on the legal concept of material breach. It's to give the layperson a better working relationship with the concept of material breach within the context of a likely hypothetical scenario – especially in light of a tightening economy where cash flows for both parties might be constrained.

Hypothetical: Assume you are the landlord of a retail development which contains common areas, the maintenance costs of which are to be spread proportionately amongst your tenants. Your oldest lease contains simple language to the effect that "…tenant shall reimburse landlord for its proportionate share of the common area maintenance expenses by April 1st of each year…," nothing more. The last page of the lease contains a provision which sets forth that "…time is of the essence with regards to the terms and provisions contained herein…." You are eight years into an initial lease term of ten years and, up until this recent credit crunch, your tenant has made all lease-related payments on time. However, on this particular April 1st, you do not receive tenant's reimbursement. On April 9th, you receive a letter (and a phone call) from your tenant to the effect that their cash flows are tight (due to the effects of the recent credit crunch) but tenant promises to get you a check for the full amount in three weeks. You further explain that if you don't get the reimbursement within three weeks, you'll have to terminate the lease and find another tenant. Your tenant promises to get the money to you within three weeks and follows up with a letter to that effect which you receive two days later. Sixteen days later, but still within the three week period as promised by your tenant, you send a letter to your tenant that you are cancelling the lease and are entering into a new lease for the premises with a new tenant. You feel justified in doing this since, at this point, the reimbursement payment is almost a month overdue. Besides, for whatever reason, you just don't feel that tenant will uphold their promise to pay.

Question: Can you declare tenant to be in material breach of the lease, terminate the lease and enter into a new lease with another retail tenant?

Discussion: Maybe. The law on material breach (in a non-goods contract) sets forth that if a party fails to perform a promise which amounts to both a material and total (i.e., no cure by the breaching party is forthcoming within a reasonable period of time) breach, then the aggrieved party may, among other alternatives, cancel the contract, enter into another contract and sue the breaching party for all damages. Whether a breach is material is ultimately a question of fact for the judge or jury to decide and there are legal tests and factors to consider in making that decision. However, instead of focusing on those tests and factors, let's just assume that the judge or jury decides that the breach by tenant is not material, thus, landlord cannot terminate the lease and enter into a new lease. What about our fact pattern would support such a finding and, more importantly, what could you learn from it?

First, although the lease sets forth that the reimbursements shall be made by April 1st, there is no language which makes such reimbursements by April 1st a condition of the agreement. In other words, the agreement does not set forth how important it is that such reimbursements be made by April 1st of each year. Without such language, landlord will be unsuccessful in claiming that tenant's failure to pay by April 1st put landlord in so dire a financial situation that it would justify landlord's termination of the lease agreement. Accordingly, when drafting such a provision, it would be advisable to include language to the effect that "…tenant's failure to tender such reimbursements to landlord by April 1st of each calendar year shall constitute a material breach of the agreement…" or, in the alternative, "…tenant's reimbursement to landlord by April 1st of each year shall constitute a condition of the agreement…." When that type of language is found within the lease, it will be easier for the court to find that tenant was in material breach when it failed to remit the reimbursement payment to landlord by April 1st.

Second, even though the phrase "…time is of the essence with regards to the terms and provisions contained herein..." appears at the end of the lease, courts have held that the use of a singular, detached "stock phrase" such as this will not, by itself, make tenant's breach of a certain lease obligation tantamount to a material breach of contract. Rather, if the parties intended for time to be "of the essence" with regard to tenant's obligation to make such reimbursements by April 1st of each year, then language to the effect that "…time is of the essence…" should have been inserted directly into the operative reimbursement provision of the lease. This would make it easier for the court to find that tenant was in material breach when it failed to pay landlord by April 1st.

Third, whether or not tenant's failure to pay by April 1st constituted a "material breach" of the lease, landlord still "jumped the gun" in attempting to terminate the lease and enter into a new lease. Why? A tenant with a history of making all lease-related payments on time was not given the chance to cure the breach by making the reimbursement payment within the three week period as promised. Put another way, after making all lease-related payments on time for eight years, landlord should have reasonably believed that tenant's cure of the breach was forthcoming. Accordingly, there was not a "total" breach of the lease by tenant which would justify landlord's attempt to terminate the lease and enter into a new lease. This does not mean landlord could not claim a partial breach of the lease by tenant and sue tenant for damages which landlord incurred by reason of tenant's failure to make the reimbursement payment by April 1st. However, it does mean landlord was not justified in attempting to terminate the lease and enter into a new lease. At the end of the day, if landlord had waited the three weeks before writing the letter to tenant, the court would be more likely to hold that tenant's cure of the breach was not forthcoming which, in turn, would increase the odds that tenant would be found to have been in material breach of the lease.

The legal concept of material breach is complicated and the analysis and application of it to any set of facts should only be attempted by qualified legal counsel.