

Nonprofit 411: The Importance of Defunding Clauses in Leases

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By Samuel Nagler, Krokidas & Bluestein

Imagine this nightmare scenario: your organization, through no fault of its own, loses its funding for a particular program. That funding was the source of your rent payments under the lease of the space from which you operated the program. You have an unsympathetic landlord who says “that’s not my problem” when you explain the situation. You miss a lease payment, and the landlord’s attorney sends you a notice to the effect that you are responsible for the full amount of the lease payments that would have been due under the remaining several years of the lease, all in a lump sum. Though you are relieved when the landlord finds a new tenant for your space who is actually willing to pay a higher rent, that relief is short-lived since under a 2007 Supreme Judicial Court case, so-called rent acceleration clauses may be fully enforceable even if the landlord has found a new tenant.



If government funding is the source of rental payments under a lease, a defunding clause – a clause that allows the tenant to terminate the lease based on loss of funding – is essential. There are many nuances involved in the drafting of a defunding clause. For example, you will want the clause to apply to a partial defunding that impacts your ability to make further rent payments, not just to a complete defunding. Ideally, the clause should specify that the determination as to whether the partial funding cut was of such significance that you can no longer make lease payments is one made solely by you, since you certainly know your organization’s financial and operational constraints better than the landlord does. However, even if your landlord agrees conceptually to a partial defunding clause, it may insist on an objective standard (such as a specified percentage cut in funding, or at least a “reasonableness” standard) for determining whether you can no longer make lease payments. The length of the notice period is also commonly negotiated. If the funding source does not give you much notice, you may not be in a position to give the landlord any greater notice. However, landlords will often insist on ninety days or even more notice. These are but two of the issues that arise in negotiating defunding clauses.

You may ask why any landlord would agree to a defunding clause when the tenant’s termination of the lease does not excuse the landlord from making its mortgage payments. While such a provision may be a deal-breaker for some landlords, from my own experience of over thirty years, landlords generally acquiesce (albeit reluctantly), especially if they are convinced that the prospective tenant’s board of directors requires that every lease contain a defunding clause. Landlords who take the time to learn a bit about your organization, your history of success, and the essential nature of the services you provide, can generally obtain enough comfort to agree to a defunding clause in some form.

Krokidas & Bluestein LLP is an affiliate member of the Massachusetts Nonprofit Network.