

BASIC ISSUES IN COMMERCIAL LEASES

PART II

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BASIC ISSUES IN COMMERCIAL LEASES - PART II

I. Assignment and Subletting.

A. Introduction.

1. If a lease is silent as to a tenant's right to assign the lease or sublet the premises, tenant may freely assign its leasehold interest.

2. Landlord's perspective.

a. Landlord wants to prohibit assignments or subletting by the tenant entirely. In addition, if the tenant is a business entity, the landlord wants to be able to control transfers of controlling interests in the entity.

b. Landlord's reasons for restricting assignments or subleases:

(i) To retain a desirable tenant in possession.

(ii) To have control over the type of business operated in the premises.

(iii) To protect landlord's investment and the welfare of other tenants.

(iv) To take advantage of a rising market.

(v) To protect and preserve percentage rental income stream.

(vi) To provide for appropriate and profitable tenant mix.

(vii) To prevent having an undesirable tenant or use.

(viii) To avoid increasing exposure to environmental or other liability.

(ix) To avoid the need for substantial alterations to the premises.

(x) To protect the landlord's co-tenancy obligations.

The assigning tenant needs to remain liable for tenant obligations under the lease.

3. Tenant's perspective.

At the very least, the tenant wants the lease to provide that the landlord's consent to assignment or subletting shall not be unreasonably withheld, delayed or conditioned.

Tenant's reasons for wanting no restrictions on right to assign or sublet:

- (i) Flexibility to dispose of premises.
- (ii) Maximize the value of lease.

4. Generally, whether the final clause regarding the tenant's right to assign or sublet favors the landlord or the tenant depends upon the market and which party has greater bargaining power.

5. Basic distinctions between assignment and subletting.

a. When a lease is transferred by assignment, the assignee steps into the tenant's shoes and acquires all the tenant's rights in the lease. Upon assignment of a lease, privity of estate no longer exists between the landlord and the original tenant, and the assignee thereafter becomes bound by all of the covenants running with the property, including the provisions of the lease. However, privity of contract between the landlord and the original tenant is not extinguished, and therefore the tenant is still liable (secondary v. primary) under the lease provisions, while the assignee becomes primarily liable.

b. Alternatively, under a sublease, the tenant relets the premises to a sublessee, thus creating a new landlord-tenant relationship between the tenant and the sublessee. The original tenancy is not terminated, but rather, continues in full force and effect. Therefore, the original tenant retains both privity of estate as well as privity of contract. No legal relationship emerges between the landlord and sublessee, so that landlord's recourse is against the tenant only. [NOTE: The subtenant will desire a non-disturbance agreement from the landlord.]

c. The test to determine whether a transfer is an assignment or a sublease may be determined as follows: If the instrument purports to transfer all of the tenant's estate for the entire remainder of the lease term, it will be considered an assignment; but if the instrument purports to transfer less than all of the tenant's estate for all or less than all of the term, it will be considered a sublease, regardless of the parties intentions.

B. Tenant's right to assign or sublet.

1. Absent a statute or express restriction in a lease, a tenant has an absolute right to assign or sublet.

2. A tenant may not sublet premises to be used in a manner inconsistent with the terms of the lease.

C. Landlord's restrictions on assignments or subleases.

1. Landlord's right to restrict tenant's right to assign or sublet in lease.

Courts will generally enforce an express lease provision that affords the landlord the absolute right to withhold consent for a tenant to assign the lease or sublet the premises.

b. Rationale:

(i) Landlord has a substantial interest in controlling the assignability of a lease.

(ii) Restriction provides the landlord the opportunity to assess experience, financials, business character, and proposed use.

c. If the terms of an assignment are clear, the provision will be enforced.

d. Such a restriction will be strictly construed.

e. A restriction against assignment may not preclude subletting, pledging or mortgaging the lease, or granting a license or executing a management agreement for the premises.

f. In the same manner, a restriction against subletting does not prohibit an assignment.

2. If a landlord has the right to consent, the tenant should seek to have excluded, at the very least, assignments to affiliates, assignments in connection with mergers and consolidations, and assignments in connection with a sale of all or substantially all of the tenant's assets.

a. Landlord concerns:

(i) Operating expense.

(ii) Financial strength.

3. Silent lease clause.

a. Common Law.

(i) Rule – Where consent of the landlord is required, and the lease does not expressly provide that the landlord's consent may not be unreasonably withheld, the landlord may arbitrarily withhold his or her consent.

- (ii) Rationale:
 - (A) Where lease provides landlord's consent cannot be unreasonably withheld in certain instances, assignments and subleases could similarly have been addressed.
 - (B) Court will not rewrite lease.
 - (C) Tenant could have bargained for a reasonableness clause.

b. Modern trend.

- (i) Rule – Where the landlord's consent is required, the landlord must act reasonably when withholding consent to an assignment or a sublease, even if the lease does not expressly require that the landlord's consent cannot be unreasonably withheld.

- (ii) Rationale:

- (A) Good faith and fair dealing – as a contract, the lease should be governed by contract principles of good faith and fair dealing.
- (B) In granting or withholding consent to an assignment or sublease, landlord must exercise his or her discretion in good faith and in accordance with commercially reasonable standards.
- (C) Reasonable alienation of commercial space has become important in the commercial real estate world.
- (D) Public policy favors the interpretation which least restricts the freedom to alienate.

c. Reasonableness.

- (i) Standard.

- (A) Landlord must act in an objectively reasonable commercial manner.

- (B) Would a reasonable person in the landlord's position have withheld his or her consent?
- (C) What is reasonable may differ depending upon the type of property.

d. Factors.

- (i) Financial responsibility.
 - (A) Past earnings of the proposed assignee or sublessee.
 - (B) Estimated future receipts.
 - (C) Insolvency or poor payment record.
- (ii) Suitability for particular property.
- (iii) Proposed use.
 - (A) Legality.
 - (B) Tenant mix.
 - (C) Alterations to the premises.
 - (D) Nature of the occupancy.
 - (E) Assignee's or subtenant's ability to fulfill the terms of the lease.

e. Applicable standards may be the same as those applied in accepting the original tenant.

f. "Tone" and "image" may be considered by a landlord in certain circumstances.

g. Examples of bad faith or unreasonableness:

- (i) Landlord leasing premises to same person previously rejected.
- (ii) Landlord's wrongful interpretation of deed restrictions imposed on leased property regarding use of property.
- (iii) Withholding consent primarily on the basis of personal taste, convenience or sensibility.
- (iv) Withholding consent so that the landlord may charge a higher rent than that contracted for with the original tenant.
- (v) Refusing to grant consent unless landlord receives one-half of the sublease proceeds.

D. Lease clauses providing conditions to tenant's right to assign or sublet or to landlord's withholding of consent.

1. Lease clause conditioning tenant's right to assign or sublet on tenant not being in default.

2. Lease clause providing that landlord shall not withhold consent unreasonably upon certain conditions.

a. Typical conditions imposed by landlord.

(i) Tenant cannot sublease or assign to a particular type of occupant.

(ii) Tenant cannot increase "traffic" within the building.

(iii) Tenant cannot negotiate with an entity that is negotiating with the landlord or has negotiated with the landlord previously within a certain period of time.

(iv) Tenant cannot assign or sublease to a current occupant of the building.

(v) Satisfactory financial condition of assignee.

(vi) Satisfactory business and operating experience of assignee.

(vii) Original tenant remaining liable.

(viii) Obtaining consent of landlord's lender.

(ix) Any increase in rent being paid to the landlord.

(x) Acceptable use, with no impact on tenant mix, percentage rent or previously granted exclusives.

(xi) Increase in minimum rent.

(xii) Tenant to pay all of landlord's expenses in connection with the assignment.

(xiii) Landlord not having any space available in the project suitable for the proposed assignee.

(xiv) Assignee or sublessee not being in a business competing with landlord.

(xv) Proposed assignee or sublessee being of a different class than tenant.

(xvi) Lease may provide reasonable use restrictions upon which the landlord may condition its consent.

(xvii) Profit.

(A) Landlord's perspective – As a condition to an assignment or sublease, a landlord may want to provide in the lease that if the tenant requests an assignment or sublease of all or part of premises, landlord will receive all or a share of the profit received by the tenant.

(B) Tenant's perspective – Tenant will want a clause providing that the tenant will, at the very least, recover its costs of improving the premises and in obtaining the assignment or sublease prior to sharing any profit with the landlord.

E. There exists authority for the proposition that a lease which requires the landlord's consent for an assignment or sublease may also provide that the landlord may arbitrarily withhold such consent.

F. Lease clause providing that prohibition against assignments or subleases includes assignments or subleases by operation of law.

1. Generally.

a. A non-assignment clause bars an affirmative voluntary act, but not an involuntary transfer, such as a transfer by operation of law.

b. To prohibit transfers by operation of law, the restriction in the lease must be clearly drafted, as the restriction will be strictly construed.

2. The partnership tenant.

a. Changes in the membership of a partnership tenant, such as the addition or withdrawal of a partner, do not violate a general non-assignment clause.

b. In order for changes in the partnership to be included in the non-assignment clause, the lease must explicitly provide.

3. The corporate tenant.

a. Merger.

(i) General non-assignment clause – such a clause is not necessarily breached by merger of corporate tenant.

(ii) Operation of laws – Where lease contains a non-assignment clause which expressly prohibits assignments by operation of law without the landlord's consent, the merger of the tenant corporation into another corporation constitutes a transfer by operation of law and therefore violates the non-assignment clause.

b. Transfer or sale of tenant corporation's stock.

(i) Sale of shares of tenant corporation's stock

to another corporation does not constitute an assignment or subletting of the premises under general non-assignment clause.

(ii) Lease clause that provides that a transfer of stock control constitutes an assignment has been upheld.

(iii) General non-assignment clause providing that the landlord's consent shall not be unreasonably withheld.

(A) Sale of stock by shareholders of tenant corporation to party that tenant had previously attempted to assign the lease to does not necessarily constitute an assignment.

(B) Merger of tenant subsidiary corporation into parent corporation does not necessarily violate non-assignment clause that expressly provides that the transfer or sale of fifty percent or more of the corporation's stock constitute an assignment.

c. Effect of dissolution.

(i) Does not terminate lease.

(ii) Vests lease and other assets of the corporate tenant in its shareholders.

d. Individual tenant estate planning/transfers to family members.

G. Lease clause providing for landlord's recapture of space or profits.

1. Space.

a. The landlord may include in the lease an option to recapture the space offered for assignment or sublease by the tenant.

b. The lease should specify:

(i) The circumstances under which the recapture clause becomes effective;

(ii) The percentage of space, if any, the tenant is permitted to sublet;

(iii) Whether the entire lease, or a portion of the

lease, will terminate upon tenant's request for landlord's consent to an assignment or subletting;

(iv) Whether the tenant's rent will be reduced in proportion to the premises recaptured;

(v) What notice the landlord will give to the tenant if the landlord intends to recapture; and

(vi) Repayment of unamortized improvements v. release of liability.

2. Issue regarding validity of lease provisions that provide that the tenant has a right to assign or sublet as long as the tenant obtains the landlord's consent, which shall not be unreasonably withheld, and that the landlord may cancel the lease.

H. Lease clause providing for percentage rent.

1. Tenant generally has a right to assign or sublet a percentage lease in the absence of an express provision prohibiting such.

2. As a result, the landlord usually wants to condition the assignment of a percentage rent lease upon the proposed tenant's gross sales being similar to the original tenant.

3. Depending on the tenant's business, the landlord may want to increase the percentage.

II. Other Issues to Consider.

A. Tenant's remedies in the event of landlord's wrongful act.

1. Some courts hold that a tenant has a right to terminate its lease or cease payment of rent if landlord unreasonably withholds consent to an assignment or sublease, in breach of its covenant to act reasonably.

2. If a lease provides that a landlord may not unreasonably withhold consent to an assignment or sublease, landlord may attempt to limit tenant's remedy to declaratory judgment.

3. Damages may also be available in an action against a landlord for wrongful refusal to consent to an assignment or sublease if damages are ascertainable.

4. Damages may not be an important issue if the landlord's liability is limited.

B. Forfeiture in the event tenant fails to obtain consent prior to assignment.

1. The general rule is that forfeitures are not favored in law.

2. Courts may have equitable power to terminate a lease in some circumstances even where the lease has no forfeiture provision. A court

may terminate a lease where the breach goes to an “essential” part of the lease, and where damages are impracticable.

3. Tenant’s failure to gain consent prior to assigning or subletting does not necessarily result in a material breach.

C. Effect of bankruptcy proceedings on an assignment or sublease.

1. Regardless of provisions in the lease, a tenant may have broad rights of assignment in bankruptcy proceedings, subject to the provisions of the Bankruptcy Code. See 11 U.S.C. § 365(b)(3). As a result, a landlord should consider ways to draft lease provisions that afford the most protection to preserve the landlord’s tenant mix, while still complying with the Code.

2. In addressing the assignability of leases in bankruptcy, Congress recognized unique qualities of shopping centers. It acknowledged that a shopping center is often a carefully planned unit, and though it consists of many different tenants, it is considered a single unit.

3. Relevant Bankruptcy Code Provision – Section 365(b)(3):

(b)(3) For purposes of [providing adequate assurance, as required in] paragraph (b)(1) of this subsection and paragraph (2)(B) of subsection (f), adequate assurance of future performance of a lease of real property in a

shopping center includes adequate assurance –

- a. Of the source of rent and other consideration due under such lease, and in the case of an assignment, that the financial condition and operating performance of the proposed assignee and its guarantors, if any, shall be similar to the financial condition and operating performance of the debtor and its guarantors, if any, as of the time the debtor became the lessee under the lease;
- b. That any percentage rent due under such lease will not decline substantially;
- c. That assumption or assignment of such lease is subject to all the provisions thereof, including (but not limited to) provisions such as radius, location, use or exclusivity provision, and will not breach any such provision, contained in any other lease, financing agreement, or master agreement relating to such shopping center; and
- d. That assumption or assignment of such lease will not disrupt any tenant mix or balance in

such shopping center.

4. Applications.

- a. The term “shopping center” is to be strictly construed, although it is not expressly defined in the Bankruptcy Code.
- b. Case law has established several objective criteria to determine whether a lease is considered a “shopping center lease” for purposes of § 365. Such criteria include: a combination of leases, all leases held by a single landlord, all tenants engaged in the commercial retail distribution of goods, common parking areas, the purposeful development of the premises as a shopping center, a master lease, fixed hours during which all stores are open, joint advertising, restrictive use provisions in leases, percentage rent provisions, right of tenant to terminate upon anchor tenant’s termination, common area maintenance, and contiguity of stores.
- c. If a proposed assignee of a debtor’s lease would have a negative effect on a shopping center by disrupting tenant balance and targeting a different consumer market, a bankruptcy court may disapprove such assignment in order to protect the landlord’s once bargained-for security and control over the character of the shopping center.
- d. Where a shopping center lease provides for a tenant’s unfettered right to assign or sublet, regardless of tenant mix, § 365(b)(3)(D) would not afford additional protection to the landlord to preserve the tenant mix.

III. Repairs and Maintenance.

A. Building v. Common Areas.

1. Common Areas.

a. Ground Lease.

(i) If common areas are included, tenant is required to maintain at least to the same standard as balance of project.

(A) Landlord self-help.

(ii) Tenant is required to maintain all components of building.

2. Building Lease.

a. Anchor tenant v. non-anchor tenant.

b. Interior.

- (i) Exposed v. unexposed.
- (ii) Tenant does not want obligation of opening walls or floors unless the need for repairs is caused by acts/omissions of tenant.

c. Exterior.

- (i) Repair v. alteration.

- (ii) Exceptions.

- (A) HVAC.

- (B) Alterations to building performed by tenant that subsequently require repair. (If the landlord didn't build it, should it be obligated to fix it?)

- (iii) Painting.

B. Repair v. Replacement.

1. Tenant only wants to repair. (Cost to replace is included in rent.)
2. Landlord wants replacement. (Tenant has benefits of improvement and should replace if needed.)
3. Common compromise is for the tenant to pay initial cost to replace, but the landlord is required to reimburse unamortized portion at end of lease term if no renewal.

C. Alterations required to comply with law.

1. Prior to delivery.
 - a. Landlord representation/warranty.
2. Subsequent to delivery.

Tenant obligation if compliance required due to tenant's specific use or construction of tenant's improvements.

Self-help rights.

IV. Property Damage and Condemnation.

A. There are fundamentally different occurrences: damaged property can be repaired, but condemned property is gone forever (except for the very rare instances of a temporary taking). Condemnation of shopping center improvements is probably unusual, but condemnation of a parking area or an access way is not.

B. However, they do share many issues. Do not use the term “CASUALTY” when referring to property damage. The term is actually used in the context of liability coverage in the insurance industry and could be confusing in dealing with property damage clauses.

C. When reviewing these provisions, consider:

1. Does the provision apply to the “premises” or the “shopping center”? If damage/condemnation of the shopping center is not discussed, the tenant might be left alone if the rest of the center is destroyed/condemned, or left without parking or adequate access. The parties should agree on a percentage loss on parking beyond which a tenant may be allowed to cancel.

2. When can the premises – and the shopping center – be repaired or restored so the tenant has what it bargained for? Does the landlord have to repair?

3. Should the repair and restoration be conditioned upon receipt of proceeds? What happens if lender has the right to apply proceeds to reduce the mortgage and therefore the landlord does not actually receive them.

4. When does rent abatement start and end? Keep in mind that lenders count on the landlord’s income stream to pay the mortgage. How does insurance factor into this?

a. Is CAM also abated?

b. Prepaid rent is not apportioned to the date of the damage/condemnation at common law so make a provision for it.

c. Do rent and CAM abate until the end of a fixturing period?

d. In the case of condemnation, what is the amount of the rent abatement, especially where less than all or even none of the premises are taken?

5. How long does the tenant have to be without the premises before it can terminate? How long does landlord have to decide if it is going to rebuild?

a. The tenant wants not only a prompt initial assurance of how long repairs will take but also actual completion in a permissible time frame. The landlord needs flexibility in case the contractor is late, and the time to process its insurance claim and rebuild.

b. There may be other tenants (the “anchors”) or areas of the shopping center (access or convenient parking) that the tenant wants and that have nothing to do with the premises. If the anchor terminates because of damage, what rights should

the tenant have? What about a taking of the tenant's best point of access or most convenient (reserved, for instances) parking?

c. General rule: repair always takes longer than imagined. Experience has shown that most time frames established in leases do not work. You must account for architectural work, permits, bids, insurance claim issues and the like.

6. In the case of condemnation, who has the right to make claim for the proceeds from the condemning authority? Should tenant and landlord file separate claims? Can they?

a. Tenant should be allowed to claim for lost profits, moving expenses and FF & E, all to the extent these do not reduce the landlord's claim.

b. Generally, the landlord will be entitled to the full condemnation claim, including the value of the leasehold estate, save the items referenced above.

V. Default and Remedies.

A. Defaults.

1. A list of defaults might include:

a. Failure to pay rent or other amounts.

b. Breach of other covenants; the "big ones" often are listed separately. Examples include impermissible assignment, or failure to open or operate. [NOTE: some lawyers feel that these are the only defaults.]

c. Abandonment of the premises or vacancy for a specified period of time.

d. Insolvency, including bankruptcy, a levy on the lease, appointment of a receiver. [NOTE: Section 365 of the U.S. Bankruptcy Code prohibits "ipso facto" or optional termination clauses and permits assignment or rejection of the lease. However, landlords still insist on including bankruptcy as a default. The landlord may want to draft extensive provisions to establish the benefits available under Section 365(b)(3) of the Code.]

e. Insolvency or bankruptcy of a guarantor, or its effort to rescind or revoke the guaranty.

f. Cross-defaults with other documents, such as the shopping center REA.

2. Notice and cure.

a. The tenant MUST have written notice and an opportunity to cure any default – including such time as is needed if the cure is being diligently pursued:

(i) This typically excludes monetary defaults, which must be cured promptly after notice.

(ii) Landlord will want to limit the number of notices given in any year for monetary defaults.

b. The eviction procedure in most states – by law or practice seems to give notice and cure rights in any event.

c. Often a lease uses the term “Event of Default” to express a default for which notice has been given and a cure period has passed.

d. When a renewal right is tied to the absence of a default, be certain that (1) it is a current default, and not any occurrence of a default that was cured, and (2) it has obtained “Event of Default” status.

B. Remedies:

1. Termination, but then the landlord’s claims end except for acceleration. The landlord needs to expressly reserve the right to damages post-termination.

2. Re-entry, pursuant to which the landlord takes possession (without accepting a surrender). In some states an express right of re-entry is a prerequisite to an unlawful detainer or summary ejectment proceeding. Landlord may then relet the premises for the tenant’s account. The landlord takes the re-rental income after deducting its costs and applies it to the rent coming due. In many states, if the landlord re-enters, it may thereafter have a duty to mitigate damages.

3. Cure, of the default by landlord with the right to recover costs, plus interest, from the tenant.

4. Suit, either monthly or at the end of the term.

5. Acceleration, by which the remaining rent (and often an estimate of CAM) is declared immediately due, but is reduced by the rental value of the remaining term. If it is not reduced, the landlord gets a windfall – the remaining rent plus the premises for which the rent is due. Often, acceleration is expressed as a liquidated damages formula, including reduction to present value.

6. Late fees and/or default interest rate charges, imposed on monetary defaults.

7. Attorneys' fees, expended by landlord in connection with tenant defaults. [NOTE: Tenant will want to make the right to recover attorneys' fees reciprocal.]

C. Mitigation.

1. Get the landlord's promise to mitigate regardless of the state of the law in the jurisdiction (which may change).

2. The definition of "mitigation," if any, should include the taking of such steps as the tenant would take to dispose of the premises including advertising, signage and a listing for lease.

3. The requirements vary, so a clear statement of what is required probably is helpful, although the tenant may have more room to argue if no safe harbor is defined. The duty to mitigate often is referred to simply as "reasonable efforts to relet."

4. Of course, the landlord cannot mitigate if the tenant still is in possession.

5. The landlord will want to qualify any mitigation obligation on first achieving full leasing of other available space in the center.

D. Surrender.

1. This is the tenant's Nirvana.

2. If a tenant can convince a court that the landlord has accepted a surrender (which can occur with something as innocent as accepting the keys from the tenant in some states), the lease is over and the tenant is off the hook.

3. When a default is imminent or has occurred, the tenant ought to look up the relevant law of surrender and try to position the landlord.

VI. Insurance

A. Property Damage.

1. General.

a. Percentage coverage (replacement).

b. Deductibles.

c. Excludes foundation.

d. Landlord coverage excludes tenant's improvements/contents.

e. Lost rental coverage v. business interruption.

- f. Minimum requirements of carrier (or if landlord/tenant want to self insure).
- 2. Ground Lease.
 - a. Tenant provides.
 - b. No suspension of rent.
 - c. Proceeds.
 - (i) Rebuild v. termination.
 - (ii) Lender issues.
- 3. Building lease.
 - a. Typically landlord provides.
 - b. Suspension of rent (covered by insurance).
 - c. Landlord obligation to rebuild.

B. Liability.

- 1. General.
 - a. Landlord and tenant each have obligation to carry liability insurance to protect against negligent acts/omissions.
 - b. Other party named as additional insured.
 - (i) Difference between additional insurance and named insured.
- 2. Common Area.
 - a. Landlord provides unless tenant is performing CAM for its parcel.
- 3. Inside leased premises.
 - a. Tenant.
 - b. Landlord has no control over what goes in within leased premises.
 - (i) Roof leaks.
 - (A) Notice from the tenant.

(B) Tenant ability to protect (warn) employees and business invitees.

B. Mutual Waiver of Subrogation.

1. Cost issue.
2. Self funded v. commercial policy.

C. Landlord insurance programs/tenant contributions.

1. Self-funded programs.
2. Actual cost v. billed cost.
3. Audit rights.

VII. Miscellaneous Lease Provisions

- A. Accord satisfaction.
- B. Successors/assigns.
- C. Net rent.
- D. Consents (standard).
- E. Gender/plural.
- F. Choice of law.
- G. Relocation rights.
- H. Waiver of jury trial.
- I. Attorney fees/interest.
- J. Alternate dispute resolution.
- K. Merger doctrine/entire agreement.
- L. No amendment.