Landlord, I'll Always Be Yours (For Now): Assignment and Subletting

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ASSIGNMENT AND SUBLETTING

or

"LANDLORD: I'LL ALWAYS BE YOURS (FOR NOW)"

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§1.01 STANDARDS FOR REASONABLE CONSENT

§1.01-1 **<u>In General.</u>** In commercial lease negotiations, the question of whether the landlord must be reasonable when approving an assignment of the lease or a sublease of the premises is often a contentious issue. One of the reasons the issue is so troublesome is that the meaning and scope of "reasonable consent" is very unclear and the landlord will be correspondingly uncertain as to how much control it has surrendered. Moreover, a good faith but incorrect response to a tenant's request for consent to a transfer[1] may yield unhappy results for the landlord—the termination of the lease for a material breach and/or the exposure to considerable direct and consequential damages.

The agreement of the landlord to be reasonable with respect to consent is an important issue as it represents, under the case law, a significant loss of control by the landlord and a large exposure for a wrong answer. If the lease merely contains the phrase **"which consent landlord agrees shall not be unreasonably withheld"** without additional guidelines or standards, the landlord will be hard pressed to come up with a sustainable justification for refusing consent and will only have the case law to rely on. The problem for the landlord is somewhat less acute in the shopping center context as courts have recognized the need for a balanced and diversified tenant mix, and have often given landlords more latitude in supporting a refusal of consent on arguably ambiguous grounds, even where the proffered assignee is not *per* se objectionable. See the discussion of *Warmack v. Merchants National Bank of Fort Smith*, 612 S.W. 2d 733, 735 (Ark. 1981), below.

It behooves both parties to try to agree in advance upon standards of reasonableness with some particularity. In a shopping center context this approach should be acceptable to a tenant provided such standards are as *objective* as possible. By doing so, a landlord can attempt to set forth those tangible factors that are important in the situation at hand in determining the acceptability of a prospective assignee or subtenant; and, a tenant can more effectively seek out a prospective transferee with the likelihood of acceptance by the landlord (or, at least, a judge). From a landlord's viewpoint the standards should be as *expansive* as possible, in order to sanction as many valid objections to a proposed transferee as possible. From a tenant's viewpoint the standards should be as *objective* as possible, avoiding criteria which merely indulge a landlord's subjectivity or whimsy. Agreeing upon a set of standards is not an easy task.

§1.01-2 <u>Reasonable vs. Unreasonable Consent vs. Bad Faith</u>

The concept of "reasonableness" in the context of the assignment clause refers, in the first instance, to the application by the landlord of *objective* standards as opposed to *subjective* ones. The standard is objective; therefore, a landlord's whimsical considerations of personal prejudice, convenience or taste are inappropriate. Mark S. Dennison, Annotation, *Circumstances Establishing Landlord's Unreasonable Withholding of Consent to Assignment or Sublease*, 69 Am. Jur. Proof of Facts 3d 191, § 6 (2012); Gary L. Hall, Annotation, *Construction and Effect of Provision in Lease that Consent to Subletting or Assignment Will Not Be Arbitrarily or Unreasonably Withheld*, 54 A.L.R. 3d 679, § 6 (2012). Conversely, "unreasonable" refers to *subjective* standards, even if put forth in good faith. These principles were enunciated in the following landmark cases in New York and New Jersey:

> Can the reasonableness or unreasonableness of refusing consent vary with the identity and activities of the landlord? If so, we are relegated not to the objective standards by which any tenant can be measured, but to wholly subjective criteria which render effective judicial review difficult, if not impossible. To the extent that rejection of a proposed subtenancy is based upon the supposed needs or dislikes of the landlord, a policy of judicial <u>disapproval</u> of such subjective criteria is discernible.

American Book Co. v. Yeshiva University Development Foundation, Inc., 59 Misc. 2d 31, 297 N.Y.S.2d 156, 160-161 (N.Y. App. Trial Term 1969) (emphasis added). And in *Broad & Bradford*, where the court stated:

[1] For purposes of this discussion "transfer" or "transferee", as sometimes used herein, shall refer respectively to both assignments and subleases, assignees and subtenants.

> Arbitrary considerations of personal taste, sensibility or convenience do not constitute the criteria of the landlord's duty under an agreement such as this. Personal satisfaction is not the sole determining factor. Mere whim or caprice, however honest the judgment, will not suffice. The standard is the action of a reasonable man in the landlord's position. What would a reasonable man do in the like circumstances? The term 'reasonable' is relative and not readily definable. As here used, it connotes action according to the dictates of reason—such as is just, fair and suitable in the circumstances.

Broad & Branford Place Corp. v. J.J. Hockenjos Co., 39 A.2d 80, 82 (N.J. 1944). See also *Van Sloun v. Agans Brothers, Inc.*, 778 N.W.2d 174, 179-80 (Iowa 2010), where the court upheld the standard that a landlord may not withhold his or her consent to a lease based on subjective factors such as personal taste, convenience or sensibility.

A. The Distinction Between "Unreasonable" and "Bad Faith".

One should not confuse or equate the concepts of "reasonableness" with "good faith" (i.e., an honest belief in one's motives), nor the concepts of "unreasonableness" with "bad faith". A landlord can be deemed unreasonable (i.e., subjective) in the context of considering whether to approve an assignment but not be guilty of bad faith. However, one who is guilty of a *bad faith* refusal of consent is always unreasonable. Bad faith goes beyond unreasonableness: it has been likened to being subjective plus lacking a moral or ethical quality.

When a landlord contracts for the right to be unreasonable in approving an assignment (which it has the right to do), this does not mean that it is also contracting for the right to act in bad faith. Consider the following hypotheticals:

<u>Example 1 – Subjectivity</u>:

Assume that a landlord is considering whether to lease space to one of two apparel retailers: Retailer A or Retailer B. Both are solid national or regional retailers with substantial financial strength and similar categories of quality merchandise.

However, the landlord prefers Retailer A because its goods are more "fashion oriented" than Retailer B's merchandise. This is a very *subjective* consideration but under the principle of freedom of contract, the landlord is permitted to do this. The landlord is indulging in very subjective criteria but is not guilty of bad faith.

However, after the lease is signed, if Retailer A thereafter wishes to assign the lease to Retailer B and there is a *reasonable consent* assignment clause, the landlord *cannot* make the same subjective distinction and turn Retailer B down on the grounds of "inferior fashion" as it did prior to signing a lease with Retailer A because now the landlord is bound by the *objective* reasonableness standard in the assignment context. Retailer B gets to come into the center by way of an assignment. This is one of the reasons why many leases permit the landlord to reject a proposed assignee or subtenant if the landlord had been in negotiations with such party in the recent past.

If the assignment clause of the lease had contained *a sole discretion standard*, the landlord could have turned Retailer B down on the same basis that landlord refused to contract with Retailer B in the first place—based on this subjective perception of fashion orientation. The landlord would have been unreasonable, i.e., subjective (which the lease permits it to be) but certainly would not have been guilty of bad faith.

B. Arbitrariness vs. Bad Faith. In addition to a subjective quality, the term "unreasonable" can also include its traditional meaning of arbitrariness, capriciousness and greed but still fall short of bad faith conduct. See the following example.

<u>Example 2—Financial Motivation</u>:

Assume again that the assignment clause of the lease has a *reasonable consent* standard and the proposed transferee is of equivalent (or better) financial strength and merchandising quality as the original tenant. However, the lease is silent as to who gets the "bonus value" or profit received from the transferee.[2] If the landlord demands appropriation of all of the bonus value as a condition of its consent, then under the case law it is universally held that this is a *per se* <u>unreasonable</u> condition. This is not because the landlord was being subjective but because it was unfair for the landlord to use the assignment as an opportunity to reap the increased market value of the real estate when it could have done so through negotiated rent increases during the term.

But, if the lease has a *sole discretion* consent standard, the landlord may require the payment to it of all of the bonus value. The tenant, by agreeing to the <u>unreasonableness</u> standard, accepted this possibility that the landlord would exact this demand. The landlord here has engaged in arbitrary action motivated purely by greed (subjectivity was not an element here) but not amounting to bad faith. Since economic opportunity such as this is a value that is supported in our culture, the landlord's motivation can be defended on that ground.

<u>Example 3—the Bad Faith Case</u>:

Assume the assignment clause has a *sole discretion* consent standard. It also provides that the parties shall split any profit received by the tenant 50-50. The original tenant now wants to transfer to a retailer who is otherwise acceptable to the landlord but the landlord demands, as a condition of its consent, that <u>all</u> of the profit be paid to it.

This conduct is certainly unreasonable. But it is also something worse than that since the parties had previously reached agreement on the profit splitting issue. The original tenant was not bargaining for this. When the tenant agreed to the sole discretion standard, it assumed it was voluntarily submitting to the right of the landlord to apply subjective or arbitrary criteria when considering an assignee—<u>not</u> the possibility that the landlord would unilaterally demand *that the lease be amended*, reneging on an agreement that was already made with respect to profit splitting. This *is* bad faith conduct.

In other words, if the lease had been *silent* with respect to profits, a demand by the landlord for all of the profits, although unreasonable, would be permissible under the sole discretion standard and would not constitute bad faith. However, since the lease in this example had provided for a 50-50 profit split, a demand for *all* of the profits—which is a demand that the lease be amended—*would* constitute bad faith.

<u>Example 4—Landlord Retains the Profit</u>:

Assume the lease has a *reasonable consent* standard but the lease expressly provides that the landlord retains all of the profit. While the case law would otherwise have held the landlord to have been unreasonable for conditioning his consent on the appropriation of the profit, in this case the profit issue had been negotiated up-front and the subject is no longer relevant to the reasonableness issue. Similarly, any question of bad faith is also irrelevant.

§1.01-3 <u>Standards of Reasonable Consent.</u> The case law has established three basic categories which would be examined by a court and any standards developed by the parties should address these areas:

i. the financial status of the proposed transferee and its ability to perform the lease obligations;

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[2] The "bonus value" or "profit" of a lease refers to (i) the key money paid to the assigning tenant in an assignment, or (ii) the *<u>excess</u>* of the rent received by the tenant (as a sublessor in a sublease) from a subtenant over the rent the tenant pays to the landlord. The bonus value is a reflection of the increase in market rental value of the premises that has occurred since the lease was originally signed. This is also often referred to as the "value of the leasehold estate."

ii. the proposed use and occupancy of the premises; and

iii. the reputation and identity of the proposed transferee.[3]

i. **Financial Considerations**. These are the most objective and the least difficult to deal with. The parties should endeavor to establish minimum financial standards (from a tenant's viewpoint, as low as is reasonable and fair) in terms of financial capacity, including creditworthiness, net worth, prior experience and a history of profitability in the proposed business. Financial standards are discussed more fully below.

ii. **Proposed Use or Occupancy of the Premises.** In the shopping center context, this is expressed most often by the concept of "suitability of tenant mix." This is of paramount importance to the landlord and at the same time, a dangerously subjective minefield for the tenant. In shopping center leases, the many facets of this standard become readily apparent. Landlords here universally insist that the "tenant mix"—i.e., the composition of retail operations—not be disrupted. The courts have recognized this principle as well: "such a shopping complex, to be successful, must contain a good 'mix' of tenants; it must have a proper balance. Too many of any kind, such as shoe stores or clothing stores, would be harmful; a complex needs a variety of shops to attract and keep customers." *Warmack v. Merchants National Bank of Fort Smith*, 612 S.W.2d 733, 735 (Ark. 1981).

From a landlord's perspective, 'tenant-mix" is the very core of the shopping center concept. If an assignee's use will remain in the same category as the original tenant, then a landlord can reasonably expect that the replacement tenant be reasonably similar to the one it is replacing. If the *use* of the proposed assignee is different from that of the original tenant, then the need to control tenant-mix is all the more acute.

From the tenant's perspective, it is undisputed that the tenant-mix concept is central to the unique nature of a shopping center but it is far from easy to agree on what that term means. Shopping center landlords often require that (i) the **"quality of operation"** and **"quality of merchandise"** be **"as good as"** the original tenant's, or (ii) the use should not **"impair the reputation of the shopping center"** as a **"first class"** shopping environment. Buzzwords such as these are very subjective and vague and reduce any standards dangerously close to the level of the personal likes or dislikes of the landlord, even if they are expressed in good faith. Moreover, in addition to its subjectivity, the "standards" often employed by landlords may (depending upon the use clause of the lease) impose a stricter yardstick and burden on the transferee than would be imposed upon the original tenant. Where the use clause of the assignee remains essentially the same, such tenant-mix safeguards and other "standards of reasonableness" tend to force the original tenant to produce a "clone" in the transferee. The more notable and prominent the original tenant is, the harder it is to find a replacement.

If the use of the premises is not going to change, then the transferee should not be more restricted in this regard than the original tenant was. If the "quality of operation" of the original tenant declined (in the landlord's eyes), then it is not reasonable to impose a stricter standard on the assignee. If the use clause

[3] For a discussion of these factors, see *Van Sloun*, 778 N.W.2d at 180, where the court enumerated several factors that weighed on whether the commercial landlord reasonably withheld consent to a sublease:

> These factors were: (1) the financial responsibility of the proposed assignees, (2) the original tenant's failure to comply with the lease conditions, (3) the original tenant's failure to indicate a willingness to remain obligated on the lease, (4) the legality of the proposed use and need for alteration of the premises, and (5) the nature of the existing use and the proposed use by the new tenant.

Id. at 180. The court held that the landlord's refusal to permit the sublease was reasonable in light of the foregoing factors. Specifically, the landlord properly withheld consent to the sublease because of the conflict between the existing use and the proposed use by the new tenant: (1) the proposed sublessor's business would be duplicative of existing operations on the premises and would disrupt the tenant mix; (2) the new business would require substantial alterations to the premises; (3) food odors from the new business could disrupt the surrounding business; and (4) the sublessor's business operations would interfere with the delivery operations of the other, existing businesses on the premises. *Id.* at 182.

is going to change, then it is appropriate to discuss standards that will give the landlord a reasonable quantum of protection.

iii. **Identity and Reputation.** Clearly, potential transferees who have a reputation for involvement in illegal activities, a poor credit history or are renowned as a troublesome tenant should be rightfully rejected and no tenant should object to such a standard in a lease. Further, it is reasonable (although courts have held otherwise) for a landlord to insist that the proposed transferee not be:

a. a tenant of the landlord in another property of the landlord lest the landlord be forced to (a) create a vacancy in its other property, or (b) accept a party with whom it would not otherwise have renewed a lease because of prior bad experience with that party; or

b. a party with whom the landlord is then negotiating for space in the center. Obviously, the landlord finds that party acceptable or wouldn't be dealing with him. However, the landlord has a legitimate interest in pursuing that relationship without (a) being prevented from filling vacant space by reason of interference from the original tenant, and (b) giving the third party an undue advantage by coming into the center through the "back door" (i.e., the assignment door) at a below-market rent.

§1.01-4 **<u>Standards Found in Landlord Lease Forms</u>**. The following is an extended list of common examples of "reasonable consent" standards often appearing in shopping center leases as landlords attempt to achieve their goal of protecting their economic interest and maintaining control over the tenant-mix in a shopping center:

A. Financial Considerations;

B. Nature of Use;

C. Clone Factors; and

D. Other Considerations.

Some of these standards often represent the most subjective of criteria. They will each be discussed in turn.

A. Financial Considerations

Financial considerations, together with tenant mix issues are key in determining whether a landlord has acted reasonably in reviewing the original tenant's request for approval of a transfer. Where a proposed transferee is not financially responsible, a court will find that the landlord's refusal to consent was reasonable. *First American Bank, N.A. v. Woods*, 781 S.W.2d 508, 590-91 (Tenn. Ct. App. 1989). Conversely, where a proposed transferee *is* financially responsible, a court will more likely find that the landlord's refusal to consent was unreasonable. *Tollius v. Dutch Inns of America, Inc.*, 244 So. 2d 467, 471-72 (Fla. Dist. Ct. App. 1970). However, even where the proposed transferee is financially responsible, other factors may outweigh a finding that a landlord's withholding of consent was unreasonable. *Kroger Co. v. Rossford Industrial Corp. Inc.*, 25 Ohio Misc. 43, 44 (1969) (finding landlord's refusal to consent reasonable, although the tenant was financially responsible, because the tenant did not specify the proposed use of property). A court will consider a proposed transferee financially responsible where the transferee can assure the landlord that it is able to perform all of the covenants of the original lease and the landlord will not suffer as a result of the sublease or assignment. Gary L. Hall, Annotation, *Construction and Effect of Provision in Lease that Consent to Subletting or Assignment Will Not Be Arbitrarily or Unreasonably Withheld*, 54 A.L.R. 3d 679, § 7 (2012); *see Jack Frost Sales, Inc. v. Harris Trust & Savings Bank*, 433 N.E.2d 941, 950 (Ill. App. Ct. 1982) (noting that to prove the lessor unreasonably rejected the proposed assignment or sublease, the tenant must prove that the proposed transferee met reasonable commercial standards).

For example, in *First American Bank of Nashville*, the proposed subtenant was a newer fast food company and did not have an extensive operating history. *First American Bank of Nashville, N.A. v. Woods*, 781 S.W.2d at 592. Although the subtenant's net worth was significantly greater than the original tenant's net worth, the larger number was largely made up of the sale of franchises as opposed to the sale of food and, therefore, it was not clear whether the subtenant would be successful. *Id*. Thus, because the proposed subtenant could not assure the landlord that it would uphold the covenant to pay rent, the court found that the subtenant was not financially responsible and the landlord acted reasonably in withholding consent. *Id.* at 592. *See also Worcester-Tatnuk Square CVS, Inc. v. Kaplan*, 601 N.E.2d 485, 489 (Mass. App. Ct. 1992) (finding the landlord's refusal to consent was reasonable where the original lease provided for percentage rent payments in anticipation of the original tenant's high-volume business and the original tenant provided no information as to subtenant's anticipated level of gross sales).

Similarly, in *Pakwood Industries, Inc.*, the court found that the proposed assignee was not financially responsible, and therefore the landlord's refusal to consent was reasonable, where the assignee was a relatively new business, had no rental history, had no significant experience in the proposed business, and while it acquired all of the tenant's assets, it pledged the assets to secure its substantial debt to the lessee. *Pakwood Industries, Inc v. John Galt Associates*, 466 S.E.2d 226, 228-29 (Ga. Ct. App. 1996).

Conversely, in *Vranas & Associates, Inc.*, the court found that the proposed assignee start-up corporation was financially responsible where the corporation was incorporated with $25,000 in cash and an approved SBA-guaranteed $200,000 loan, it already tendered the $5,000 security deposit, it had given the landlord the security assignment of all fixtures and inventory, and the president had provided his own personal financial statement and copies of the SBA loan agreement. *Vranas & Associates, Inc. v. Family Pride Finer Foods, Inc.*, 147 Ill. App. 3d 995, 1004, 498 N.E.2d 333, 339-40 (Ill. App. Ct. 1986),

The most common financial standard found in a shopping center lease is the one that requires that:

i. **The net worth of the transferee is equal to or greater than the higher of the net worth of the Tenant (i) at the execution of this Lease, or (ii) the time of the proposed transfer;**

A net worth test *is* appropriate but it must relate to the ability of the tenant to pay the rentals and perform the other obligations of the lease without an inordinate risk of repeated defaults. It is not necessarily relevant to compare it to the net worth of the original tenant, and completely irrelevant to relate it back to the time the lease was signed. The inquiry should <u>not</u> be "who did I have before?" but rather "who do I have now?" Is the proposed assignee's financial strength sufficient to perform the lease obligations? Since we are just talking about whether the landlord must be reasonable in approving an assignment, net worth requirements in the tens or hundreds of millions are simply absurd.

The landlord is entitled to have a tenant who can regularly pay the rent and perform the lease obligations and is not likely to default. However, this does not mean a transferee of the same (or better) financial status than that of the original tenant. The relevant question is "how much is enough" in this context and, perhaps, what financial strength the landlord would have reasonably accepted in the first instance.

a. <u>Net Worth Equal to Tenant</u>. Leases which require a transferee's net worth to be equal to or higher than that of the original tenant, especially when the original tenant is very strong, are excessive. If two tenants had been competing for the same space—one with a $100 million net worth and one with $150 million—it is doubtful that the landlord was driven by the higher net worth of the second tenant since both net worth figures far exceed the requirements of any lender. Rather, the landlord would be influenced by the rent negotiations and the quality differences (subjective) between the two prospects. Any argument that the landlord simply "relied" on the $150 million net worth of the second tenant and nothing else would be suspect.

In addition, leases which require that the net worth be at least equal to the tenant's net worth at the time the lease was signed or at the time of the assignment, <u>whichever is higher</u> are excessively unreasonable, especially for purposes of the reasonable consent issue and particularly in the case of large companies. If the original tenant had a net worth of $100 million when the lease was signed and a net worth of $200 million today, then how could a transferee with a net worth of $150 million be unacceptable when it exceeds the net worth of the original tenant at the time the original lease was signed. Is it realistic to expect that the financial condition and operating performance of the potential assignee be "similar" to that of the original tenant on Day One (or at the time of the assignment, if that is higher)?

Conversely, if the tenant's original net worth was $100 million when the lease was signed but declined to $15 million because of business reversals or a leveraged buyout, that is certainly a risk the landlord usually takes and can do nothing about. Thus, he cannot impose a condition on the acceptability of the transferee at the time of transfer that is more burdensome than that borne by the original tenant. The landlord acquires no assurance that the net worth of the original tenant will increase or a guarantee against its decline.

b. Relationship to Release-of-Liability. Often a tenant will negotiate for its automatic release of liability under the lease if the assignee has a certain net worth. This amount will generally be designed to give the landlord a measure of *additional* security beyond that necessary to assure the daily performance of the lease obligations. Therefore, *release-of-liability* net worth figures will (and should) be higher than the net worth figures which simply determine whether the landlord will be reasonable in reviewing a proposed assignment.

c. The Correct Answer. What the appropriate net worth figure should be is a matter for a case-by-case negotiation, but generally, for average sized retail stores at typical rent levels, a figure in the range of $10 million is sufficient to ensure the daily performance of the lease obligations without having to repeatedly call upon the original tenant, as guarantor, to make good on the assignee's defaults.

d. Subleases/Financial Standards Waived For Subtenant? The financial standards should not apply in determining whether the landlord will be reasonable in consenting to a *sublease* because the tenant-sublessor will continue to pay the rents directly to the landlord. The landlord will not even experience the subtenant from a financial point-of-view. A landlord will argue, however, that a financially strapped subtenant may not be able to perform the other lease obligations, such as the repair of the premises or the continued operation of the store, notwithstanding that the original tenant will continue to pay the rent.

ii. **The transferee shall have a net worth equal to $1 million per store location operated by such party.**

The test that the transferee have a net worth equal to $1 million per store location operated by such party does not make much sense as the net worth of a company is not directly proportional to its store count growth. Only giant retailers could meet this ratio. Ironically, a retailer who was *closing stores* would eventually meet this test more easily than a thriving and growing merchant, by reason of the over-simplified arithmetic of this test.

Other Financial Tests.

a. Current Ratio. Landlords argue that net worth numbers, by themselves, are of dubious value if most of the net worth is tied up in long term capital assets, not easily convertible into cash. A current ratio is the ratio of current assets (i.e., liquid assets like cash or merchandise) over current liabilities (as distinguished from payments under long term mortgages). Accountants look to this ratio as a measure of the assignee's *liquidity.* A current ratio requirement of 1.1 to 1 would be acceptable to an assigning tenant. What this number means is that the assignee has to have $1.10 in current assets for every $1.00 of current liability.

Landlord often ask for ratios of 2 to 1 or more. In reality, however, many retailers' (especially apparel retailers') current ratios are not all that much greater on average than 1.1 to 1; those of some national chains *rarely* approach 2 to 1. The current ratio varies during the year based on inventory levels at various times and outstanding amounts owed to vendors. Further, it is somewhat naive to assume that a soft goods retailer with a solid positive net worth would have most of its resources tied up in long term assets. Therefore, a liberal ratio, which is good for all seasons, is all that is necessary.

b. Ratio of Total Liabilities to Tangible Equity. This ratio measures how "leveraged" the assignee is. A ratio of 4.5 to 1 would be acceptable to an assigning tenant. In this example, the assignee has to have $4.50 of debt for every $1 of equity.[4] The adjective "tangible" would exclude certain intangible, abstract assets such as goodwill or money paid to acquire a lease (i.e., key money).[5] *See Louisiana Casino Cruises, Inc. v. Capitol Lake Properties, Inc.*, 845 So. 2d 447, 449-50 (La. App. Ct. 2003) (holding that the landlord reasonably denied its consent in a case where the long-term debt to equity ratio of the proposed assignee was twice the industry standard).

c. Credit Ratings. These tend to be too stringent for the simple purpose of determining whether the landlord has to be reasonable when reviewing a proposed transfer and they should be avoided for this reason. They are more relevant to the issue of the *release* of the original tenant upon an assignment.

iii. **In Landlord's reasonable judgment the receipt by Landlord of percentage rent shall not decline;**

This is intended to protect the landlord from a low volume producer when it was relying upon the high sales volume of the original tenant to generate percentage rent. There are a number of cases that upheld the landlord's refusal to grant consent on this ground where the percentage rent clause is a crucial component of the rent structure and the nebulous character of a percentage rent clause makes the identity of the tenant and its sales producing capability a matter of considerable importance to the landlord.[6] This is also the standard devised by the International Council of Shopping Centers and enacted into the Bankruptcy Code to determine whether a proposed transferee in a bankruptcy case will afford the landlord "adequate assurance of future performance." 11 U.S.C. § 365 (2012).

From the tenant's perspective, it represents a substantial burden to find a transferee, although conducting the same use, that will produce the same sales per square foot as the original tenant. Compare the sales of two successful retailers in the same business and one will not get identical numbers. Further, if the original tenant had *not* been paying percentage rent for a long while before the transfer, how realistic is a test that the percentage rent due under the lease will not substantially decline upon a transfer? And if the original tenant *was* paying percentage rent, how likely is it that it would be attempting to assign its lease?

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4 Assets minus liabilities = equity or net worth.

5 Key money is booked as a capital asset (lease acquisition cost) and is depreciated over time but is considered an "intangible" asset.

6 *See Norville v. Carr-Gottstein Foods Co.*, 84 P.3d 996, 1002 (Alaska 2004) (noting that where the sublease of a portion of a store was perceived as sufficiently threatening the landlord's expectation of receiving percentage rent, as to reasonably justify landlord's rejection of the proposed sublease); *Newman v. Hinky Dinky Omaha-Lincoln, Inc*., 512 N.W.2d 410, 415 (Neb. Ct. App. 1994) (finding the lease allowed the landlord to prevent the assignment or sublease when the proposed transferee would not produce an adequate amount of percentage rent to guarantee a "fair return on investment"); *Worcester-Tatnuk Square CVS, Inc. v. Kaplan*, 601 N.E.2d 485, 489 (Mass. App. Ct. 1992) (noting the landlord reasonably withheld consent to a food market's sublease of a portion of the property to a pizza shop where no information was given to the landlord about the anticipated level of subtenant's gross sales nor any assurance that the remaining space would be used to generate sales that might result in greater percentage rent); *Haack v. Great Atlantic & Pacific Tea Co.*, 603 S.W.2d 645, 650-52 (Mo. Ct. App. 1980) (holding the landlord did not unreasonably withhold consent to a sublease by the supermarket to a furniture store where there was no reasonable likelihood that sales of a furniture store would approach the percentage rent breakpoint amount in supermarket lease to generate percentage rentals); *Jonas v. Prutaub Joint Venture*, 567 A.2d 230, 232 (N.J. Sup. Ct. App. Div. 1989) (noting the landlord was not unreasonable in refusing consent to a transfer of a lease of a high volume franchise to an operator who was inexperienced in the business). Some of these courts have also used the provisions in leases to "maximize gross sales" as secondary support for allowing a landlord to withhold consent.

To avoid becoming embroiled in a factual determination of this issue in a lawsuit, the solution is to provide in the assignment clause that the minimum rent will be "stabilized," i.e., increased to the sum of the minimum rent plus the percentage rent (if any) payable over the last twelve months immediately preceding the transfer. In this way, a landlord will not lose any ground from the situation as it existed in the recent past, although there is no guarantee that it will continue to receive percentage rent in the future (there never was any such guarantee).

iv. **The transferee shall have had at least three years of experience in the Permitted Use and has experienced profits for two of those three years;**

It is reasonable, in a shopping center context, to expect that the transferee will not soon thereafter go dark for lack of financial resources or for lack of experience in conducting the permitted use. This would also apply to proposed *subtenants* despite the fact that the original tenant (the sublessor) pays the rent and *technically* "performs" the lease obligations directly for the benefit of the landlord.

v. **That the transferee be an operator of a "chain" of comparable size (or some minimum number of stores);**

This is not only an excessive standard for reasonable consent purposes but it also requires the tenant to produce a "clone" in the transferee. The larger the tenant is, the harder it is to find a replacement. However, where the original tenant is a chain of substantial size, it may be acceptable to require the assignee be a chain of *some* (moderate) size, e.g., ten to fifteen stores.

vi. **That the economic terms (or other terms) of the Lease be amended in any manner.**

Many leases often provide that upon a transfer, or, the landlord's consent shall be deemed reasonably refused, if the tenant or assignee refuses to:

a. increase the rent;

b. pay over to the landlord all of the bonus value; or

c. agree to some other modification to the lease.

Although this issue may be presented as a "standard of reasonable consent," it is actually a *condition* to the landlord's consent. In either case this requirement would destroy an assignment transaction unless the transferee was willing to go along with it. If the lease had provided for reasonable consent but was silent on these matters, such condition would be considered unreasonable *per se* under the case law. The court cases are legion that increasing the rent (or for that matter, requiring any amendment of the lease) as a condition of consent or that the only justification for refusal was to renegotiate a higher rent is *per se* unreasonable.[7] *See D.L. Dev. Inc. v. Nance*, 894 S.W.2d 258, 260-61 (Mo. Ct. App. 1995)

[7] See, for example, *Kendall v. Ernest Pestana, Inc.*, 709 P.2d 837 (Cal. 1985) (en banc), where the court held that it is not commercially reasonable for the landlord to deny consent to a sublease so he or she may charge a higher rent than what was originally contracted. *See Julian v. Christopher*, 575 A.2d 735, 739 (Md. 1990) (holding that a landlord's refusal to consent to a sublease solely for the purpose of securing a rent increase is unreasonable); *Ringwood Associates, Ltd. v. Jack's of Route 23, Inc.*, 379 A.2d 508, 512 (N.J. Super. Ct. Law Div. 1977), *aff'd*, 398 A.2d 1315 (N.J. Super. Ct. App. Div. 1979) (finding landlord's refusal to consent to tenant's proposed assignment of lease was unreasonable because the landlord did not question the solvency of the proposed assignee, where no alterations to premises were necessary for the assignment, where the landlord did not object to nature of assignee's business, and where only apparent reason for refusing the assignment was the landlord's desire to rent directly to the proposed assignee under new lease at higher rent); *Economy Rentals, Inc. v. Garcia, et al.*, 819 P.2d 1306, 1317 (N.M. 1991) (noting that landlord's refusal to consent to a sublease was unreasonable where the real motivation was increasing its economic benefit from the lease). *See also Buck Consultants, Inc. v. Glenpointe Associates*, 217 Fed. Appx. 142, 148-49 (3rd Cir. 2007) (noting that the landlord unreasonably withheld consent to a proposed assignment when the proposed tenant was suitable to the premises and was financially secure, and the landlord "repeatedly attempted to

(holding that a landlord unreasonably withheld consent to sublease where the landlord conditioned consent on a renegotiation of the underlying lease, which would have resulted in improving the landlord's economic position). The landlord should be bound by its original bargain and if it failed to provide for rent increases over the course of the term, the courts will not rescue the landlord by supporting a denial of consent to an assignee upon the same rent structure. This is especially true when rent increases *are already built into* the lease. Courts will additionally find that a landlord unreasonably withheld consent to an assignment or sublease where the only justification for doing so is to rent directly to the prospective assignee or sublessee.

Closely related to this issue is the requirement that the landlord receive all profit or "bonus value" to be paid by the transferee. Absent the tenant's express agreement to it as a condition of consent, this is also unreasonable since it is really the equivalent of raising the rent to present market value. See *National Union Fire Ins. Co. v. Rose*, 760 N.E.2d 791, 911 (Mass. App. Ct. 2002), where a commercial tenant was not required, pursuant to a profit-splitting provision in the lease, to charge sublessee a rent in excess of what the tenant was paying, and thus the landlord unreasonably withheld consent to sublet on this basis.

Whether these provisions are expressed as "standards" of reasonableness or "conditions" (which is what they really are), the following often appear in leases:

a. <u>Rent Increases</u>. These clauses can require increases in rent computed by:

raising it to fair market value (as determined by arbitration). This should be unacceptable to the tenant;

increasing it by the Consumer Price Index Increase. This should be unacceptable to the tenant;

increasing the minimum rent it to the "effective" rent or "stabilizing" the rent, i.e., the sum of the minimum rent and percentage rent (if any). This *would be acceptable* to a tenant.

b. <u>Profit</u>. The boilerplate clauses in landlord lease forms require the tenant to pay over to the landlord all of the profit received from the transferee. When coupled with raising the rent in Items (a)(1) or (a)(2) above, this is a form of double-dipping. However, there is no incentive for the tenant to try to secure a bonus value payment that will ultimately go to the landlord. The tenant will just assign the lease or sublet the premises for only the "sticker price," that being the unamortized cost of the tenant's leasehold improvements (which the tenant always gets to keep). The landlord may find itself presented with a below-market assignment or sublease without *any* compensation therefor. This possibility should be an *incentive* to the landlord to agree to share the profits with the tenant (who will be incentivized in turn to get as much as it can) rather than insist on a clause which appropriates them all—there just may be no profit for that very reason. The parties often agree to a 50-50 profit split after the tenant first recoups its remaining undepreciated leasehold improvement costs and other expenses. This addresses the landlord's craving to reap the benefits of a rising rental market when the original tenant is no longer in possession.

B. Nature of Use

i. The Premises shall continue to be conducted under the Permitted Use;

This is acceptable provided the use clause is not tenant-specific or brand specific by name, e.g., for the sale of "XYZ" labeled wearing apparel or "ABC" computers. For example, if the use clause required the premises to be operated as an "Apple Store" selling Apple branded electronics, then if Apple desired to assign its lease to Microsoft (same use category), how could the transaction proceed if Microsoft were only allowed to sell the Apple brand of product?

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extract higher profits from [the proposed tenant] by offering to exchange its consent to the sublease for an extended and expanded direct lease with higher rents").

a. Different Use. If the *assignment clause* of the lease provides for the landlord's reasonable consent but the *use clause* allows only a specific use and provides that the premises may not be used **"for any other purpose or purposes,"** is the landlord acting reasonably when it refuses to consent to a transfer if the proposed transferee intends to conduct a different use? Aside from the "existing exclusive," "no duplication" and "tenant mix" provisions discussed below, may the landlord simply refuse to consent since landlord was under no compulsion to agree to a change in the use clause?

Courts are in conflict as to whether a landlord is unreasonable in withholding consent to an assignment or sublease when the original lease specifies a particular use of the property and the transferee's proposed use does not fit within the parameters. In *Van Geffen, Jr.*, the court found that the landlord reasonably withheld consent to a proposed sublease to an orthodontist because the use clause in the original lease restricted the use of the premises solely to the practice of general dentistry and the practice of orthodontics is not included in the practice of general dentistry. *Van Geffen, Jr. v. Herbert*, 439 So. 2d 1257, 1258 (La. Ct. App. 1983). This is in contrast to *Astoria Bedding*, where a retail bedding store attempted to sublease its premises to a packaging and mailing service company under a lease which required that the landlord's consent would not be unreasonably withheld. *Astoria Bedding, Mr. Sleeper Bedding Center Inc. v. Northside P'ship*, 657 N.Y.S.2d 796, 797 (N.Y. App. Div. 1997). The landlord refused its consent to this change in use on the ground that the *use clause* required that the premises be used **"only"** for a bedding operation**.** *Astoria Bedding, Mr. Sleeper Bedding Center Inc.*, 657 N.Y.S2d at 797. The court found that the landlord unreasonably withheld consent, stating that the landlord's **"sole reliance on the purpose clause . . . cannot be deemed reasonable as a matter of law;"** rather, a landlord must still look to objective factors such as financial ability and suitability to reasonably withhold consent. *Id*. at 797 (emphasis added). While upholding the landlord's right to restrict the use of the original tenant on the one hand, the court was also influenced by the fact that there was no such condition imposed upon an assignment or sublease. *Id*. at 797.

As observed by William Coskran:

> There is a close relationship between transfer restrictions and use restrictions when the proposed transfer involves a change in use of the premises by the transferee. The transferee is subject to the use restrictions in the lease. If the lessor is subject to a reasonableness standard in giving or withholding consent to a transfer, a proposed change in use involves factors to be considered in the reasonableness test. Some of these factors were specifically mentioned by the court in the Kendall decision. They include: legality and suitability of the use; the need for alterations; and the nature of the occupancy; the tenant mix in a shopping center. Thus, a lessor who wishes to restrict transfer should look carefully to the drafting of a use clause. Absent a restriction on use, a lessor will have a difficult time meeting the reasonableness standard when he or she objects to a transfer on the basis that the transferee will change the use of the premises. If the tenant can change the use, the lessor has no legally enforceable expectation that the use will remain the same.

William G. Coskran, *Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 LOY. L.A. L. REV. 405, 536 (1989).

It is prudent practice for the tenant to (a) avoid name-specific or brand-specific limitations and, (b) provide in its *use clause* that consent by the landlord to a change in use of the premises will not be unreasonably withheld, delayed or conditioned. This is not to say that a court would not still support a landlord's refusal to consent in the context of an enclosed regional mall where a balanced tenant mix is recognized as important (although perhaps less so in a strip center). But, at the very least, the provision would require an inquiry into the circumstances surrounding the proposed transfer.

ii. **The proposed use would have an adverse impact on the tenant mix of the Shopping Center;**

This is the quintessential expression of the "tenant mix" principle. Without any parameters, however, it reduces the reasonable consent clause to one of pure subjectivity and whimsy. Where the *use* to be conducted in the premises is the same or similar to that of the original tenant, there is no plausible argument a landlord could raise to defeat the entry by the transferee into the shopping center on this ground. Where the use to be conducted in the premises is *different from* the permitted use (see discussion below) some preservation of the tenant mix principle is warranted. In *Ernst Home Center, Inc.*, a home center store attempted to sublet its premises to a second hand clothing outlet, Value Village, but the landlord declined its consent alleging that the tone and image of its center would suffer. *Ernst Home Center, Inc. v. Sato*, 910 P.2d 486, 490 (Wash. Ct. App. 1996). While the court held that "tone" and "image" considerations were subjective in nature, they were nevertheless were appropriate for the landlord to consider in reviewing an assignment of a commercial lease for space within a shopping center and that it was incumbent upon the trier of fact to determine whether the landlord's refusal—in the context of a reasonable prudent person in the landlord's position—was also objectively reasonable. *Id.* at 493-94. The Court upheld the trial court's finding that the landlord failed to meet its burden of proof on this issue and thus acted unreasonably in refusing to consent. *Id*. at 494.

In *Cafeteria Operators L.P.*, a landlord was held to have reasonably withheld consent to a sublease of a cafeteria style restaurant to a non-cafeteria style restaurant. *Cafeteria Operators L.P. v. AMCAP/Denver Ltd. Partnership*, 972 P.2d 276, 277 (Colo. App. 1998). The trial court found that the subtenant would disrupt the tenant mix to the detriment of the center because the subtenant would be the largest restaurant of its kind, raising concerns about lighting, maintenance, traffic, and parking. *Cafeteria Operators L.P.*, 972 P.2d at 279. Moreover, the subtenant would sell alcohol and stay open late, increasing the average seating time, and raising concerns about security, safety of patrons, and parking requirements. *Id*.

The "tenant mix" concept is also addressed by the following standards:

iii. **The proposed use will not violate any exclusive agreement contained in any lease between Landlord and any other tenant in the Shopping Center;**

The tenant's first response should be that: "that this condition shall be deemed complied with so long as the proposed assignee or subtenant shall conduct the business in the Premises in accordance with the "Permitted Use." So long as the *assignee* is within the scope of the use clause, it should not have to be concerned about exclusives in favor of others. As mentioned above, however, this condition only has relevance if the transferee's use will *change* from that of the original tenant. However, even here, the obstacle to successfully completing the assignment is that a poorly drafted exclusive granted *after* the original lease was signed but *prior* to the proposed assignment (an "intervening exclusive") may render that transaction impossible.[8] Some limitation on this condition would be required in the case of the such exclusive. The intervening exclusive must:

a. be stated with reasonable particularity so that a reasonable person can determine the use, merchandise or class of protected merchandise,

b. not otherwise prohibit the original tenant's use clause in any way;

c. provide that the use or merchandise being protected is then the primary use of the intervening exclusive holder;

d. require that such intervening exclusive holder is open and operating, and

e. provide that the intended transferee is not prohibited from the reasonable incidental conduct or sale of the protected use or merchandise.

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[8] However, in a street deal or strip center, where a tenant often is permitted to conduct <u>any lawful use</u>, it is not uncommon (but it is unwise) for the tenant to agree to honor <u>future</u> exclusives with respect to business that it is not already engaged in.

In *Pay 'N Pak Stores, Inc.*, the court upheld the landlord's refusal to consent to a sublease which would compete with the landlord's own business. The court stated that:

> [A] legitimate reason for a landlord to prevent subletting of the premises is 'to protect the lessor's interest in the preservation of the property and the performance of the lease covenants.' It is reasonable to argue that protection from competition which diminishes the landlord's business is not general economic protection [which *Kendall* proscribes] but is specific protection in his ownership of the particular property. That is particularly true where the subleased property is in the same shopping center where the landlord has his business and the landlord might have validly included a restricted use clause in the lease for the very purpose of protecting the business interests of other tenants in the shopping center.

Pay 'N Pack, Inc., 258 Cal. Rptr. at 819 (quoting *Kendall*, 709 P.2d 837 (Cal. 1985)).

iv. **The proposed use will not duplicate the use of another tenant in the center;**

A "non-duplication" provision is extremely difficult to draft and difficult to administer when seeking out a proposed transferee, especially since the landlord is the one making this very subjective determination and one cannot know, until a transferee is presented to him, when that line has been crossed. At least with an exclusive clause in favor of a third party tenant, some limitations would—hopefully—be drafted into the clause by which the original tenant can be guided in its efforts to find a transferee.

Where another existing tenant in the shopping center did not negotiate an exclusive for itself, that tenant would nevertheless enjoy an exclusivity by virtue of this "non-duplication" provision while being unaware that it even exists. Once the original tenant agrees to this "non-duplication" concept in the context of an assignment, the implication is created that with respect to product lines not yet carried by the assignee but arguably within the use clause of the lease, those lines would nevertheless be <u>barred</u> if another tenant already carried them. That other tenant would, by implication, have an exclusive on everything it carries so long as it carried those goods before the assignee did.

This provision is the landlord's way of enforcing non-competition and maintaining control over the tenant mix. However, given the fluidity of use clauses in modern shopping center leases and the extensive overlapping of product lines, a non-duplication clause grants the landlord the power to reject a broad range of proposed transferees if it so chooses.

Nevertheless, if faced with a non-duplication requirement in the lease negotiations, a tenant should secure, at a minimum, a provision that the non-duplication provision:

a. would only apply to stores of a size equal to or larger than the original tenant's premises;

b. the use in question would be for a use which it is not customary for multiple stores selling the same type of merchandise to be located within the same shopping center and would cause an excessive concentration thereof in the center; or

c. such use would overburden the shopping center facilities (e.g., an additional restaurant).

v. **The proposed transferee shall not generally conduct what is known as a "discount" or "off-price" operation or sell merchandise which are irregulars, seconds or factory damaged goods;**

a. <u>Until Another Tenant Does It</u>. This would have to be modified by the tenant as follows: **"provided however that this condition shall not apply if any other tenant in the shopping center engages in such business or business practices."** The landlord has a legitimate interest in preventing the deterioration of the premises and the shopping center into a discount operation and may reasonably impose a "no-discount" condition, provided that the center isn't already heading in that direction by virtue of the businesses of the other tenants and the landlord is not diligently enforcing its other leases. The landlord no longer has a legitimate interest in preventing the premises from being used as a discount operation if he has permitted (or suffered) other tenants to do so.

The landlord may argue that this is an impossible standard for the landlord to meet, especially if some older leases do not have this restriction but in the meantime the landlord is trying to prevent further deterioration.

b. Definition of "Discount. Another complication is defining what is meant by a "discount" or "off-price" operation. The most common understanding of "discount" is when the price of an article of merchandise is marked down from a higher price. But what of the "value priced" retailer whose *everyday* "full price" is the same as the *marked down* price of the discounter described in the previous sentence? One would suspect that the landlord is really attempting to keep out both types—retailers whose pricing is at the lower end of the scale, thereby suggesting a "schlock" operation. A tenant would argue that a value priced assignee is less objectionable than a true discounter and that a distinction between the two should be made.

vi. **General Observation.** As one can see from the above discussion of the foregoing standards it is far from easy to agree on what the phrase "tenant mix" or "preserving the nature of the use" means. All of the buzzwords described here are very subjective and reduce any standards to the level of the personal likes or dislikes of the landlord, even if they are expressed in good faith. Further, these "standards" tend to impose a stricter yardstick and burden on the transferee than would be imposed upon the original tenant or require the original tenant to produce a clone in his transferee.

vii. **Other "Nature of Use" Standards.** The following standards, often appearing in shopping center leases, are hopelessly subjective and subvert any effort to arrive at a meaningful set of standards for reasonable consent. In particular, in Item (c), below, the term "first class" is the most frequently used and abused expression in use and assignment clauses. It means one hundred different things to one hundred different people:

(a). **The operations of the proposed transferee will not, in Landlord's reasonable judgment, adversely affect the drawing power, image or other valuable aspect of the Shopping Center;**

(b). **In the reasonable judgment of Landlord, the proposed transferee as well as such transferee's business is of a character such as is in keeping with the standards of Landlord for the Shopping Center;**

(c). **The conduct of business by the transferee shall be consistent with the "first class" character of the building.**

C. Clone Factors

The following standards are "clone factors," where the landlord is pursuing an impossible dream—to create a clone of the original tenant. With a few exceptions, these standards would make it virtually impossible to effect an assignment because such a tenant would be impossible to find.

i. **The Premises shall continue to be conducted under the Trade Name;**

The requirement that the transferee operate under the "Trade Name" is no different than the transferee be required to comply with other provisions of the lease except however that with respect to the trade name clause, the *very identity* of the tenant and its transferee is involved. If the trade name clause is too restrictive and specific to the *original tenant*, then the landlord may, in effect, reject an assignment because he has no obligation to approve (and may in its *sole discretion refuse)* a change of the trade name regardless of what the assignment clause says. The result to the tenant is the same—an assignment has been thwarted at the whimsy of the landlord.

It is true that in many assignments, particularly of small businesses, the name of the business is sold to the assignee along with the lease, the furniture and fixtures and inventory. It is also true that in the sale of an entire chain <u>as a going business</u> to another parent entity, the name will pass with the transfer. In these cases an invisible change of ownership occurs; the outward appearance of the tenant remains the same.

However, in the case of most transfers involving one or more stores of a national chain with an enormous goodwill built into its name, such name (or permission to use it) will <u>not</u> pass with the transfer.

Therefore, it is important for the tenant to make it clear that:

i. The landlord may *not* turn down an assignment because:

1. the name will change, or
2. the new tenant's name has less prominence than the original tenant, and

ii. When the landlord's consent to a trade name change is required, such consent will likewise not be unreasonably withheld, and

iii. When the landlord's consent to an assignment is <u>not</u> required, then *no* consent to a trade name change is required. Or, at the very least, the requirements for a no-consent trade name change must be very liberal and easy for the assignee to meet. For example, if the test for a no-consent, multi-store *assignment* is three stores in the State, then the *trade name test* must be no stricter than that. Otherwise, the assignee would have to get the landlord's permission to use the new name despite the fact that the assignment transaction itself would not have required the landlord's consent.

Unless the foregoing precautions are followed, a no-consent assignment may be corrupted into a *consent-required* transaction and a *reasonable consent* assignment clause can be corrupted into a *sole discretion* transaction, both by virtue of the trade name clause.

ii. **The character of Tenant's business shall remain substantially unchanged by the transferee;**

This requirement is impossible to meet because the phrase is so ambiguous one cannot know what is meant by the term "character" so that one cannot know what it is that must not change. The tenant would never know what to look for in a potential transferee.

iii. **The number of employees at the Premises will not be substantially reduced;**

This is an unnecessary requirement. Every business is different and is run differently, even within the same use category. There is no way an assignee could assure the landlord that it will use the same number of employees as its predecessor or that to do so is even necessary.

iv. **The principal product lines and quality thereof sold on the Premises will not be materially changed;**

This is an unrealistic requirement. Given the continuing evolution of merchandise within a given use category, this would not be a permissible (let alone manageable) restriction upon the original tenant *in the absence of an assignment* so long as the original tenant was operating within the scope of its *use clause*. Why should this be invoked at a point in time when the original tenant is assigning the lease to a third party? Whether the lease is in the hands of the original tenant or an assignee thereof, "principal product lines and the quality thereof" will change for better or for worse.

Even more unacceptable is the case where the landlord's intention was to retain the principal *brand* carried by the original tenant. As noted above, if Apple desired to assign its lease to Microsoft (same use category), how could the transaction proceed if Microsoft were only allowed to sell the Apple brand of product? Real estate developers (and their lawyers) are out of their element in dictating the branding, the supplier and type of product line within a permissible scope of merchandise. Changing brands is something the original tenant could have done without the landlord's permission; therefore, the restrictions upon the assignee would be more stringent than they were upon the assignor.

v. **The overall quality and reputation of the merchandising operation of the proposed transferee, including the nature, type, retail price structure and volume of merchandise offered for sale by the proposed transferee ("Quality Factors") is at the same level as the Quality Factors of the Tenant;**

This standard as well as the two that follow immediately below are the very epitome of cloning.

vi. **The transferee shall enjoy the same national reputation and prestige as the Tenant;**

vii. **The assignee's drawing power will not be less than the Tenant's and the assignee shall continue to provide a fair balance of customer traffic;**

All of the requirements of Items (ii) through (vii) above exemplify the pursuit of an impossible dream—to create a replica or carbon copy of the original tenant. In particular, if a tenant is at the top of its field in reputation and success, how can any transferee qualify? In the context of such a tenant, producing a clone would be impossible, rendering an assignment or sublease also impossible. Each retail operation, even those within the same use classification, is unique in many important respects. To cling to the fantasy that the landlord can preserve things just as they were before the transfer renders a transfer virtually impossible to effect.

D. Other Considerations

i. **The proposed transferee shall not then be a tenant of any space in the Shopping Center;**

The landlord may have no desire, for a variety of reasons, to continue a relationship with a particular tenant who is leasing other space from the landlord. It is not unreasonable that the landlord require that it not be burdened with continuing such relationship through the assignment vehicle. Also, the landlord may be negotiating with such party for a renewal. If that other tenant were to take an assignment of the lease from the tenant (a) the landlord's negotiations with that party would be circumvented and the other party would be attempting relocation within the center at below market rent through the assignment route, and (b) the landlord would wind up with an empty space. This qualification is also closely related to the following one:

a. <u>Exception.</u> The following type of transaction should be exempted from this standard. Assume the original tenant wishes to assign its lease to a retailer who is conducting the same use as the original tenant but the transferee happens to be a merchandising division of an existing tenant in the shopping center. An example would be where the original tenant is a children's wear retailer and the proposed transferee is the children's wear division of another retailer in the shopping center who sells adult apparel in the other store. The proposed transferee may be merely a merchandising division of the other retailer and not a separate corporate affiliate thereof and hence is the same corporate entity as the other tenant. Although this would be a technical violation of the "standard" because the proposed transferee is another "tenant" in the shopping center, clearly this transaction would not be objectionable to either party because the original tenant's use clause is being honored and there is no vacancy being created in the other space.

ii. **The proposed transferee shall not have negotiated for the leasing of any space in the Shopping Center within the previous six (6) months;**

If the landlord and another party failed to consummate a lease for whatever reason, it is not unreasonable for the landlord to insist that same party not be forced upon him by means of the assignment clause.

iii. **The Premises will not be subdivided;**

It is not reasonable to reject a transfer simply because it involves a sublease of a portion of the premises without taking into consideration the size and configuration of the space involved. Often the tenant feels the need to downsize its store to more efficiently run its business and control its occupancy expenses rather than exit the center completely. Partial sublets must not be barred completely except perhaps in the case of a store which is very small to begin with.

On the other hand, the landlord is legitimately concerned that the space not be carved up into numerous odd configurations, unsuitable for leasing if the landlord has to take the space back in the future. Thus, it *is* reasonable for a landlord to limit the number of subdivisions of the premises, particularly in a shopping center. The landlord should not be forced to accept the "Balkanization" of its property into unrentable configurations upon a recovery of possession**.**[9]

A reasonable compromise would be a requirement that the premises not be subdivided into more than two spaces (three spaces if the premises is 12,000 or more), each of which must be "regular" in shape and suitable for leasing. Often the parties will agree upon a minimum square footage and frontage for each of the sublet spaces.

iv. **The proposed use shall not materially increase the burden on building services;**

If the use by the assignee were going to change from the former use, e.g., from apparel to a restaurant, pet store or plant store, then the services required by such new uses are obviously more burdensome than required by an apparel use and the landlord has a right to consider the assignee in light of these circumstances.

v. **That any mortgagee of Landlord has refused to consent to the assignment or sublease;**

This is a problematic standard. All loan documents, whether the mortgage instrument itself or a collateral assignment of rents and leases, will provide that the landlord (borrower) not permit an assignment of the lease or sublease of the premises without the lender's consent. In practice, very few assignment clauses in landlord lease forms address the situation where the *lender's* refusal to consent excuses the landlord from having to grant its consent. Further, very few landlords may actually go to the lender for consent to individual assignments or subleases (at least with respect to leases for stores under a certain size).

Where the lease is silent on the point, the tenant is always subject to a rejection on this ground in those cases where the landlord might actually consult with his lender before he approves an assignment. One could reach a conclusion very easily that the landlord *is* being reasonable if his lender refuses to approve the assignment or sublease. If the landlord is under a reasonableness standard but the lender acted unreasonably or arbitrarily, is the landlord held accountable? If the landlord were inclined to approve the assignment but the lender refused on *reasonable* grounds, is the landlord held accountable? Is it better to

[9] See *Time, Inc. v. Tager*, where it was held that "[t]he owner of a prestige building, in order to maintain its status and desirability, may well require that space in its building be rented in substantial blocs lest the premises be Balkanized so that it becomes generally known as a veritable rabbit-warren of 'holes-in-the-wall' and rented desk spaces." Time, Inc. v. Tager, 260 N.Y.S.2d 413, 415-16 (N.Y. Civ. Ct. 1965).

not address the problem at all, trusting that in the absence of a loan default, the lender won't even know about it?

This question usually arises when the tenant is attempting to obtain a nondisturbance agreement from the lender. Many lender nondisturbance forms contain a covenant on the part of the tenant that the tenant will not assign the lease without the lender's consent. Lenders have a *financial* orientation and do not usually appreciate a real estate developer's frame of reference, where the latter party is ready to approve the transfer. Tenants will want to avoid this obligation when negotiating a nondisturbance agreement and simply attempt to get the lender to recognize successors and assigns of the tenant pursuant to transfers which were made in accordance with the assignment clause (without any reference to lender approval).

vi. **That Landlord be paid any sum or fee in consideration for the assignment or subletting or for the request for Landlord's consent thereto;**

Other than a nominal "review fee" of $500, for example, the tenant should not have to pay over any other sums to the landlord. The most common instances would involve the payment to the landlord of any "profits" or "bonus value" of the lease.

vii. **The proposed assignment or subletting shall prohibit any further assignment or subletting;**

This is an unnecessary condition since the assignment/subletting clause of the lease, as negotiated by the original tenant, should continue to govern. While some landlords would prefer to make the entire assignment clause, if it is as liberal one, personal to the original tenant, this concept must be firmly rejected. If the assignment clause in the hands of the assignee is more restrictive than when the original tenant was the tenant, this will make the lease less attractive to that assignee and thereby render the lease unmarketable even by the original tenant. Thus, the original tenant will find itself with an unsalable lease despite the permissiveness of the assignment clause. Therefore, the following modification should be added: "**the proposed assignment or subletting shall prohibit any further assignment or subletting <u>on terms and conditions more liberal than are provided for in this Lease</u>.**"

viii. **In the case of a sublease, that such party is not requesting a nondisturbance agreement from Landlord;**

Many leases provide that upon a termination of the lease for any reason, all subleases, *at the landlord's sole election*, shall deemed assigned to the landlord. Knowledgeable subtenants will ask for a nondisturbance agreement from the landlord at the time consent to the sublease is sought. A subtenant who is otherwise acceptable to the landlord should not be dispossessed upon a termination (voluntarily or otherwise) of the master lease. Thus, a request by that subtenant for nondisturbance protection should not be a reasonable ground for a rejection of the transaction.

ix. **That the original tenant not be in default under the lease;**

In *Gladliz, Inc. v. Castiron Court Corp.*, the tenant's lease provided that the landlord's consent to an assignment or sublease would not be unreasonably withheld but that it would not be deemed unreasonable to withhold consent where the tenant was in default under any of the terms, covenants or conditions of the lease, either when consent was requested or upon the effective date of the assignment. *Gladliz, Inc. v. Castiron Court Corp.*, 677 N.Y.S.2d 662, 664 (N.Y. Sup. Ct. 1998). During a period when the tenant *was* in default, the tenant attempted to assign the lease twice but landlord's consent was denied in each case for various reasons, including the tenant's default. *Gladliz, Inc.*, 677 N.Y.S.2d at 666-67. Although a third assignment was ultimately approved, the tenant sued the landlord for lost profits it suffered by reason of the first refused assignment and other damages. *Id*. at 665. The court held, *inter alia* that the landlord's consent was not unreasonably withheld as the tenant acknowledged its default status. *Id*. at 666-67.

Compare this result with the law in California. In California, a lease may absolutely prohibit a transfer [CAL. CIVIL CODE § 1995.230 (2012)] and it may absolutely restrict the use [CAL. CIVIL CODE § 1997.230 (2012)]. But if a tenant has breached the lease and abandoned the property, then a landlord may keep the lease intact and sue the tenant for damages as they accrue so long as (i) the tenant's right to possession is not terminated, and (ii) the lease may be assigned by the defaulting tenant under restrictions *that are not unreasonable*. CAL. CIVIL CODE § 1951.4 (2012). In addition, the California Civil Code Section 1951.4 remedy [continue the lease in effect and periodically sue for the rent] is still available, even in the presence of the absolute use restriction, **"except to the extent the tenant proves that under all the circumstances enforcement of the restriction would be unreasonable."** CAL. CIVIL CODE § 1997.040 (b) (2012) (emphasis added). In effect, therefore, an absolute prohibition on transfer and change of use will be relaxed to a reasonableness scenario when the tenant is in default.[10] This result codifies leasing practice in California where landlords inserted absolute prohibitions on assignment and subleases in the assignment clause to preserve their absolute control over transfers when the tenant was not otherwise in default but then relaxed the requirements to a reasonableness standard in the default clause so as not to jeopardy their default remedies.

§1.01-5 Remedies If Landlord Is Unreasonable. If it is determined by a court or arbitration panel that the landlord was unreasonable in withholding its consent to a transfer, what recourse does the tenant have? There are three basic remedies the tenant can pursue:[11]

Institute an action for specific performance requiring the landlord consent to the assignment;

Bring an action for damages resulting from the breached covenant; and

Consider the lease terminated and vacate the premises.

i. **Termination**. The ability of the tenant to terminate the lease is a potent remedy. Whether the tenant could avail itself of this remedy depends upon whether the lease is considered a *conveyance* of an interest in real estate or a *contract*. If it is a *conveyance*, the traditional doctrine of independent covenants would not permit the tenant to suspend performance under the lease—the tenant merely has a cause of action for damages for breach of the covenant. If the lease is considered a *contract*, then the doctrine of mutuality of covenants applies and the tenant would be excused from performance by reason of the failure of the landlord's performance, just like in any other contract.[12] If the assignee had sufficient net worth to have made possible the release of the original tenant from further liability under the lease had the landlord approved the transfer, then clearly the original tenant should be permitted to terminate the lease on account of the landlord's wrongful refusal.

ii. **Specific Performance**. Often the following clause will appear in a landlord's lease form (usually hidden in the Miscellaneous Provisions):

Figure 1.01-1

No Liability For Damages

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[10] In many jurisdictions where court cases implied a reasonableness standard in assignment situations, those cases involved circumstances in which the tenant was in default and there was a compulsion to afford the tenant some relief. Thus, it cannot be conclusively stated that those jurisdictions are in the "reasonableness" camp when a transfer is proposed in the absence of a tenant default.

[11] *See* Byron R. Lane, Comment, *Kendall v. Ernest Pestana, Inc.: Landlords May Not Unreasonably Withhold Consent to Commercial Rent Assignments*, 14 PEPPERDINE LAW REVIEW 81, 101 (1986) (noting also that the tenant may assign the lease without the lessor's consent).

[12] *See supra* William G. Coskran, *Assignment and Sublease Restrictions: The Tribulations of Leasehold Transfers*, 22 LOY. L.A. L. REV. 405, 510-11 (1989). *See Ringwood Associates, Ltd. v. Jack's of Route 23, Inc.*, 379 A.2d 508, 516-17 (N.J. Super. Ct. Law Div. 1977), *aff'd*, 398 A.2d 1315 (N.J. Super. Ct. App. Div. 1979).

"Whenever in this Lease express provision is made that Landlord shall not unreasonably withhold or delay its consent, Tenant's sole and only remedy for Landlord's breach of such agreement shall be limited to an action for specific performance or declaratory judgment and in no event shall Landlord be liable for any damages to Tenant nor shall Tenant be entitled to terminate this Lease by reason thereof."

This has to be one of the most unfair provisions in the lease. Having agreed to be reasonable with respect to consent, which may have included the imposition of numerous stringent and subjective standards, the landlord is not even willing to stand behind its decision and bear the consequences if it is wrong. Indeed, the landlord has no incentive whatsoever to be reasonable even if the assignment clause requires it. The landlord could reject every proposed transferee in every instance and for any reason. If the tenant brings a lawsuit and the landlord is found to be unreasonable (and assuming the transferee is still around to conclude the transfer), then the only consequence to the landlord is that it will be required to consent to the transfer. The landlord has nothing to lose by refusing to grant consent on each occasion. In *Gladliz, Inc.*, the lease contained such a limitation and this was a principal bar to the tenant's relief (aside from the fact that the landlord was found to have acted reasonably since the tenant was in default, a condition of reasonable consent). *Gladliz, Inc.*, 677 N.Y.S.2d at 664.

It must also be remembered that if the tenant were to obtain a money judgment for damages, it would still be limited, in a shopping center lease, to recovery against the landlord's interest in the real estate under the Exculpation (i.e., non-recourse) Clause. However, the above provisions removes such damages entirely from the scope of landlord's responsibility and allows the landlord to escape the consequences of its wrongdoing (or its wrongful, but good faith judgment). This should be totally unacceptable to a tenant.

One solution is to provide for an *expedited procedure* where the issue of the reasonableness of the landlord's refusal is quickly determined in sufficient time for the tenant to successfully conclude the transaction. The procedure would entail the following:

the issue of whether the landlord's refusal to consent was reasonable under the circumstances would be tried by an expedited arbitration procedure (20-30 days), presided over by real estate attorneys. In the meantime the rent would be paid into an escrow;

if the landlord wins, the escrowed rent would be paid over to it and the relationship between the landlord and the original tenant continues as before;

if the landlord loses (i.e., is found to have acted unreasonably) <u>and</u> if the transferee is still available to complete the transaction, then the landlord would be compelled to consent to the transfer and the escrowed rent would be apportioned between the transferee and the original tenant;

if the landlord loses but the transferee is no longer present or willing to complete the transaction through no fault of the tenant, then the tenant could <u>cancel</u> the lease and the escrowed rent would be refunded to it. In addition, the landlord would have to pay to the tenant the profit (if any) that the tenant would have received under the profit splitting clause had the transfer been completed. This is no different in result than the outcome of *Ringwood*, *supra*, where the landlord's material breach (unreasonably withholding its consent) excused performance under the lease by the tenant. *Ringwood*, 379 A.2d at 516-17. It just gets the parties to that conclusion a lot faster.

This is also similar in outcome to the situation where the landlord has a right of recapture in the lease but declined to exercise it, choosing to refuse consent on "reasonable" grounds. Under the right of recapture procedure the landlord may decide to cancel for the most arbitrary and unreasonable of grounds. If instead, however, it elects to forgo recapture, keeping the tenant on the lease, and rely on the merits of its refusal, then the landlord cannot complain if its unreasonableness or arbitrariness brought about the same result as the recapture right would have. The only difference here is it has been brought about by the tenant taking the landlord to task for its refusal to consent.

§1.02 LANDLORD'S RIGHT OF RECAPTURE/TENANT'S OFFER-TO-SURRENDER

§1.02-1 <u>In General</u>. The topic of whether the tenant should be subject to the landlord's reasonable consent versus sole discretion consent in an assignment/sublease situation is often a heated conflict in the negotiations and was explored in Section 1.01 of these materials. While many landlords would be content to control the tenant under a reasonableness standard (with, perhaps a negotiated set of standards), others are extremely sensitive over the issue of the *quality* of the tenant in their premises. Aside from considerations of a financial nature (and appropriating all of the bonus value of the lease), those landlords are uneasy about the loss of control over the identity of the new tenant in their space. If one of those landlords owns a fashionable mall or a prime commercial property in an upscale neighborhood or if the premises is in the best location in the center, that landlord is very conscious about maintaining the quality level of the tenant mix, as well as the reputation and image that each tenant brings to the property.

These are considerations that only *subjective* criteria can satisfy and are beyond the bounds of what is permissible under a reasonableness standard, which is based largely on *objective* factors alone. Because a landlord may feel that the reasonableness standard is too drastic of a loss of control and a wrong decision by the landlord can result in substantial damages,[13] it will often insist on the ultimate instrument of control—the right to terminate the lease upon a request by the tenant for consent to an assignment or sublease. This is referred to as the "right of recapture."[14]

Because of the uncertainties involved, a landlord may only agree to a reasonable consent clause, with all of the negotiated standards, upon the condition that it *first* have a right to exercise sole discretion at the outset through the mechanism of a right of recapture.

A right of recapture works in the following manner:

§1.02-2 <u>Right of Recapture</u>. With the traditional right of recapture, the tenant goes out into the marketplace, makes a deal with an assignee or subtenant and then presents that person to the landlord. The landlord then has the choice to either:

a. terminate the lease (and pay to the tenant the remaining unamortized amount of the tenant's improvement costs);[15] or

b. allow the transaction to take place, subject to its <u>reasonable</u> consent.[16]

i. **Special Note:** An election by the landlord *not* to terminate, followed by a *sole discretion clause* should <u>never</u> be agreed to by the tenant. The reason for agreeing to the recapture procedure in the first instance is to give the landlord the opportunity to be arbitrary, but with some important choices to make—i.e., to terminate <u>or</u> be subject to the vagaries of the reasonable consent

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[13] If the landlord is judged to be unreasonable and the tenant has lost its deal, the damages could be substantial. See the discussion under Section 1.01 (Standards of Reasonable Consent), particularly Section 1.01-5.

[14] Often, the term "recapture" is also used to refer to the taking or splitting of profits upon an assignment or sublease. However, in this discussion recapture refers only to the right of the landlord to terminate the lease and recapture the premises upon a request by the tenant for consent to an assignment or sublease.

[15] Most landlord drafted recapture clauses provide for this reimbursement as part of the lease form. The landlord's form in *Carma Developers (California) v. Marathon Development California* did not so provide. *Carma Developers (California), Inc. vs. Marathon Development California, Inc.*, 259 Cal. Rptr. 908, (Cal. Ct. App. 1989), *rev'd* 826 P.2d 710, 722-24 (Cal. 1992). Nevertheless, the California Supreme Court upheld the recapture provision according to its terms, despite the harshness of those terms. *Carma Developers (California)*, 259 Cal. Rptr. at 729-30. The point is certainly negotiable.

[16] In street deals or strip shopping centers the tenant is often bargaining for the right to assign or sublease <u>without</u> the landlord's consent. If the tenant has agreed to be subject to a right of recapture procedure, then it will insist that the landlord's decision <u>not</u> to recapture the premises results in the <u>automatic</u> approval of the assignee or subtenant, without any further necessity of obtaining landlord's consent under *any* standard.

standard. If the landlord declines its opportunity to terminate, then the landlord is subject to the reasonableness standard and had better exercise due care in rendering its decision.

ii. **Advantage to Tenant of the Right of Recapture**. If the store is doing poorly and the tenant wishes to mitigate its losses by assigning the lease to another, then a termination by the landlord is even preferable to an approval of the assignment. If the tenant is not released from liability upon an assignment,[17] it will have continued responsibility as a guarantor for the performance of the assignee. With a termination, the tenant is released from further liability.

iii. **Disadvantage**. An assignee might have been willing to pay the tenant some money for its leasehold improvement costs. Further, if the property has increased in rental value even though it was a poor performer for the original tenant, the assignee or subtenant may have been willing to pay the increased bonus value of the lease to the tenant.

With a recapture clause in the lease, these sums may be jeopardized. The recapture clause may have contained no obligation on the landlord's part to reimburse the tenant for its improvement costs upon a recapture. The tenant would thereby lose such sums that an assignee had offered to pay. Also, if the lease had contained a division-of-profits clause, the tenant would have shared some of that increased rental value. However, if the lease is terminated by the landlord under a recapture clause, the tenant's share of the profit would be forfeited and would go to the landlord.

As discussed below, a solution is to require the landlord, upon a recapture, to pay the tenant its remaining improvement costs and the profit it would have received had the assignment or sublease been approved.

iv. **Another Disadvantage**. Under many right of recapture clauses, landlords retain the choice of *either* terminating the lease or rejecting the assignment under a *sole discretion* standard. The landlord has reserved all of his options and the tenant has no leverage in the situation. As mentioned above, this scenario is <u>unacceptable</u>.

v. **Serious Disadvantage**. If the tenant is attempting to sell this site, along with other locations as part of a package deal to a potential buyer in a multi-store transaction,[18] a right of recapture could destroy the deal if this location was a fundamental part of the bargain. This would be a serious disadvantage. For this reason the tenant must exempt multi-store deals (and all other "no-consent" transactions) from the right of recapture.

A. Standards For Right of Recapture.

In a right of recapture situation, a sophisticated landlord will try to impose standards describing the quality of the prospect that the tenant must present *before* the landlord is forced to make a hard decision of whether to cancel the lease or be subject to the vagaries of the reasonable consent clause. Thus, for example, the tenant cannot bring a prospect who is so bad (e.g., an Army-Navy surplus store) that the landlord is forced to cancel. This is provisionally acceptable so long as the standards describe some pretty extreme and objective situations and do not indulge in subjective considerations such as "image," "drawing power," "quality and reputation," etc., of the type described under Section1.01 above "Standards Of Reasonable Consent." The parties will often agree to a "forbidden use" list of extreme noxious uses, with respect to which the landlord may exercise a sole discretion refusal without having to make a cancellation decision.

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17 Either because there is no release of liability provision in the assignment clause or, if there is, the net worth of the assignee is not sufficient to qualify for a release.

18 See the discussion in Section 1.03-4, below.

B. The Right of First Refusal.

Another (and clever) version of this control device is the "right of first refusal" in the landlord's favor**.** Under this procedure, the tenant presents a proposed assignee or subtenant to the landlord. The landlord then has the right of first refusal to accept the deal on the same basis, i.e., to become the assignee or subtenant of the tenant. If there was increased rental or premium paid by the assignee or subtenant, then landlord, *as the subtenant*, pays it to the tenant *as its sublessor* (but subject to profit splitting in the landlord's other capacity as the tenant's landlord).

The landlord would argue that the tenant cannot complain about this procedure since it puts the tenant in exactly the same position it would have been had the assignment or sublease been approved. While this would seem to be an acceptable arrangement, it is a method by which the landlord gets to have its cake and eat it too. Under the traditional recapture scheme, the landlord must choose between *terminating* the lease or approving the transfer under a reasonable consent clause (or perhaps with no right to consent at all). But under this arrangement, if the landlord is unwilling to terminate the lease and lose the tenant's signature,[19] the landlord still gets to control the space under an absolute, sole discretion standard, extend rent relief to the tenant but not lose the security of the tenant's credit. Further, under this device, if the landlord relets the premises, *as a sublessor*, to another retailer or assigns to another retailer in order to generate some revenue from the space, the original tenant is still responsible for the lease obligations if that remote party defaults (although the landlord would, as a sublessor or sub-assignor also be responsible).

i. **Not a True Right of First Offer.** Some of the harsher versions of this procedure attempt to allow the landlord complete freedom of action in the space as follows:

a. the clause may provide that if the proposed assignee was willing to pay key money for the space, the landlord nevertheless is excused from having to pay such sums to the tenant. If a subtenant were willing to pay more subrent to the original tenant than the rent the original tenant is required to pay to the landlord, the subrent is deemed to be reduced to the same level as the lease rent, thereby releasing the landlord of any obligation to pay the excess;

b. the landlord would have complete freedom to alter the space as it deems fit; or

c. the landlord would have complete freedom of assignment and subleasing with respect to the space.

As one can see, the hazards for the original tenant are considerable under this "right of first offer" procedure are considerable. When faced with this procedure, the original tenant should incorporate the following into the clause:

d. If the lease has provision for a release of liability of the original tenant if the assignee had a sufficient net worth,[20] and if the assignee had sufficient net worth to release the tenant from liability if the assignment had been approved, then the landlord must accept the deal on the same basis and release the tenant. In that respect, this procedure would be identical to the traditional right of recapture; and

e. In a sublease situation, the landlord must eliminate all liability of the original tenant for defaults of the subtenant (including remote successors thereof), must indemnify the original tenant for all obligations under the lease and name the original tenant as additional insureds under the insurance coverages required by the lease.

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[19] If the tenant is a sizeable company, its lease will be a "credit" lease and one of the supporting pillars of the landlord's financing.

[20] See the discussion in Section 1.05, below.

The only exposure for the original tenant should be when the proposed sublease called for a subrental which was less than the lease rent, the original tenant is only liable to the landlord for the deficiency and nothing more.

ii. **Better Solution For Tenant**. As the disadvantages of a recapture provision outweigh the benefits, the tenant should seek to avoid this mechanism in favor of the "offer-to-surrender" procedure hereinafter discussed.

§1.02-3 <u>Offer-to-Surrender</u>. The fairest way in which the landlord can be given the ability to use a sole discretion standard to control the space (or the amount of rent paid for it) while at the same time allowing the tenant the opportunity to get its improvement costs back is though the device of the "offer to surrender."

i. **Tenant Not Required to Produce Assignee/Subtenant**. With a traditional *right of recapture*, the tenant must first go out into the marketplace and find an assignee or subtenant. The tenant then presents that party to the landlord who gets to take a look at the prospect and make its decision. By contrast, under the *offer to surrender* procedure, the tenant does not have to find a prospective assignee or subtenant at all. The tenant merely approaches the landlord with an expressed desire to surrender the premises (or a portion thereof if it is just downsizing). If (a) the landlord is fearful about the quality of the assignee or subtenant that the tenant will eventually present to him (which assignee or subtenant the landlord may be forced to accept under the reasonable consent standard), or (b) the landlord wants to reap all of the increased bonus value of the premises for itself, the landlord can elect to terminate, even for subjective, personal reasons that would be considered unreasonable under the "reasonable consent" standard.

ii. **Payment of Unamortized Improvement Costs If Landlord Cancels.** If the landlord *does* accept the tenant's offer to surrender, the landlord must also pay to the tenant the remaining unamortized amount of the tenant's leasehold improvement costs. The rationale for this requirement is that by terminating the lease, the landlord has deprived the tenant of the opportunity of securing an assignee or subtenant who would pay the tenant for these costs. Further, if the real estate has appreciated in value, the tenant might also have been able to realize profit or the "bonus value" of the lease from an assignee or subtenant. Since the tenant is giving up that opportunity, it cannot also be required to forfeit the ability of recovering its out-of-pocket costs from the landlord.

Landlords are not enthralled with this procedure because they have to make a difficult decision without complete knowledge or information. They must either terminate the lease and lose the strength of the tenant's signature or be practically forced under the reasonableness standard (or *actually* forced under the "no-consent" standard) to accept an assignee or subtenant they might otherwise reject.

iii. **If Landlord Does Not Cancel—Reasonable Consent**. In enclosed regional shopping center leases, all the tenant seeks is a reasonable consent clause. The landlord is the party who first raises the issue of a termination right—usually in the form of a traditional right of recapture scheme. The tenant then convinces the landlord that the only acceptable way to deal with the termination concept is through the offer-to-surrender procedure. The ability of the landlord to terminate the lease is its opportunity to control the space under the most arbitrary of circumstances. Once the landlord has declined its opportunity to terminate, that concept is now behind the parties and they return to the issue of reasonableness, which is what the tenant wanted in the lease.

iv. **Street or Strip Center Deals—No Consent**. In street deals or strip shopping centers, the tenant is often bargaining for the right to assign or sublease *without* the landlord's consent. If the tenant has agreed to undergo an offer-to-surrender procedure, thereby allowing the landlord to indulge in sole discretion criteria in making a decision of whether or not to terminate, then the landlord's decision to forgo a termination returns the parties to the tenant's original position—the ability to proceed to assign or sublet without the landlord's consent.

v. **Tenant's Right to "Side-Step" In Street/Strip Deals**. In street or strip center deals (where the tenant was seeking the right to assign or sublease *without* the landlord's consent), the tenant may want to keep its options open and not be subject to the possibility of lease termination. The tenant can reserve the right to "side-step" the offer-to-surrender procedure and simply come to the landlord for his reasonable consent, after the tenant has gone out into the market and secured a potential assignee or subtenant.[21]

§1.02-4 Other Considerations.

i. **Tenant's Right to Offer a Portion of Premises**.

a. Offer to Surrender. Whether or not the tenant may offer up a *portion* of the premises depends upon whether it has the right to effect a partial sublet of the premises under any standard. Assuming that it *does*, then partial offerings of the premises are permitted. If the landlord terminates, the lease is only cancelled *pro tanto* to the extent of the portion offered up. In larger spaces the tenant will insist on the right to effect partial sublets, subject to some reasonable limitations as to number, size and configuration.

b. Right of Recapture. Following the same logic, if the tenant presents a subtenant of a portion of the space, the landlord can only terminate as to that portion.

ii. **Permitted (No-Consent) Transactions Are Exempt From This Procedure**. "No-consent" transaction can be effected without the landlord's consent. Accordingly, the landlord may not frustrate all of the policies underlying those permitted transactions either by a right of recapture or offer-to-surrender. See the discussion in Section 1.03.

iii. **Change of Control Transactions.** In a change of control transaction there is the presumption that a transferee already exists. Therefore, an offer-to-surrender procedure cannot work here. The transaction will either be subject to the landlord's reasonable consent or not subject to his consent at all, depending upon the balance of the assignment clause. A change of control transaction which is also a "no-consent" transaction can simply be effected without any concern about the landlord's consent.

In a *right of recapture* context, so long as the tenant presents the transaction to the landlord before it happens (as it is required to do), the transaction will play itself out according to what the parties agreed to, just as in the case of an ordinary assignment or sublease. If the tenant has effected a change of control in violation of the lease, it is subject to the same penalties as in the case of an unauthorized assignment.

iv. **Landlord Needs More Than Thirty Days to Decide**.

a. Offer-to-Surrender. The landlord will argue that since there is no assignee or subtenant on tenterhooks awaiting the landlord's decision, there is no rush and the landlord should have three to six months to make a decision. However, the tenant continues to pay rent during this period and the longer the landlord takes, the longer it is before the tenant can try to mitigate its situation if the landlord does not terminate. Thirty days to decide should be the maximum allowed to the landlord.

b. Right of Recapture. Since the tenant has a party waiting who might slip away if the landlord takes too long**,** the landlord *must* decide within thirty days. During this time it will have had sufficient the opportunity to react to the tenant's prospect and also to test the market.

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[21] The reason the tenant may want to do this is if there is a substantial profit to be made in an assignment or sublease because of the increased market value of the real estate and the lease contains a profit-splitting clause. While the termination of the lease and the release of the tenant is a benefit to it, if the tenant already has a release of liability provision in the lease and is reasonably certain it can secure an assignee with sufficient net worth and be released anyway, the tenant will want to preserve the opportunity to realize profit.

v. **Tenant May Withdraw Request If Landlord Elects to Terminate**. This would only apply in a right of recapture situation, not in an offer-to-surrender situation. If the landlord elects to terminate, the tenant may withdraw the request for consent and reinstate the lease. If there is no profit splitting clause and the landlord retains the right to appropriate all of the profit, or, the landlord has not agreed to reimburse the tenant for its improvement costs upon a recapture, the tenant may want to preserve its options for a future request. At that time, the landlord may be more confident about another prospect. If that party has agreed to pay the tenant something for its leasehold improvements, then the tenant may be able to convince the landlord to allow the tenant to retain these funds.

vi. **Landlord to Pay Tenant the Profit Tenant Would have Earned**.

a. <u>Offer-to-Surrende</u>r. Since the tenant has not yet gone out into the market, there is no demonstrable profit yet. All that the tenant seeks from the landlord is the reimbursement of the tenant's remaining improvement costs.

b. <u>Right of Recapture</u>. Assume that the parties have agreed to split profit or bonus value 50-50. If the tenant then presents a prospect under an arrangement in which the tenant was to receive consideration or profit, then if the landlord elects to terminate the lease, the landlord should pay the tenant the profit the tenant would have received had the assignment or sublease been approved.[22] Otherwise, the landlord could use the recapture device to make a direct deal with the proposed assignee or subtenant and cheat the tenant out of its share.

If the assignment or sublease is approved, the profit split would be calculated in a series of arithmetical steps as follows:

1. Consideration received from transferee less Rent paid by Tenant to Landlord = Gross Profit
2. Gross Profit less Tenant's Costs = Net Profit
3. Net Profit is split 50-50 with the Landlord.

A more detailed breakdown of Tenant's Costs:

a. Tenant's Remaining Improvement Costs;
b. Leasing Commissions;
c. Alterations performed for assignee/subtenant;
d. Other costs including attorneys' fees.

However, if the lease is terminated, the Tenant's Costs would be different:

a. Tenant's Remaining Improvement Costs;
b. Other costs including attorneys' fees.

See Section 1.04 below for further discussion of these issues.

Since the lease was terminated by the landlord, there was never a broker's commission paid, there were no alterations made for the assignee or subtenant and there may or may not have been "other" expenses.[23] Thus, the landlord must pay the tenant (1) the tenant's remaining improvement costs, plus (2) other expenses, if any, plus (3) 50% of the remainder. Since the tenant's costs will be less, Net Profit will be more and each party's share will be greater.

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[22] If profits were to be earned over time under a sublease, the amount paid to the tenant would have to be discounted to present worth.

[23] See the discussion in Section 1.04, below.

vii. **Two Bites At The Apple: Landlord Wants Both Procedures**. On occasion the landlord may attempt to retain the right to use *both* procedures. This would work in the following manner:

a. Step One: Offer-to-Surrender. The tenant would make the offer in the usual manner, asking for reimbursement of its remaining improvement costs. The landlord declines to accept the premises and then the tenant procures an assignee or subtenant and the right of recapture comes into play.

b. Step Two: Right of Recapture. The tenant presents the assignee or subtenant to the landlord and awaits its decision. If the landlord terminates, what does it owe the tenant? The tenant argues that the landlord must pay those amounts the tenant would have received had the transfer been approved but in any event not less than the tenant's remaining unamortized improvement costs. But what if the assignee or subtenant was paying the tenant an amount which was *less* than the tenant's remaining improvement costs or was paying the tenant nothing at all? The landlord would argue (with a great deal of persuasiveness) that the tenant overestimated what it thought it would fetch on the open market and that the landlord should not have pay the tenant any greater amount than the market value of his lease.

However, from the tenant's viewpoint, the tenant should not be caught in this double bind. The landlord must pursue these procedures *in the alternative*. The landlord *must* cover the tenant's remaining improvement costs if, under the offer-to-surrender procedure, the landlord elects to terminate and before the tenant has gone out and tested the market. But, if the landlord forces the tenant to go out in the market because the landlord declined to terminate, the landlord must take its chances that it will have to pay more to get the space back. The landlord should not force the tenant to negotiate against itself by undergoing both procedures. It must be remembered that, even in the absence of a specific lease provision about it, the tenant always had the *right* to offer the space back to the landlord on whatever terms the tenant desired. However, the offer-to-surrender procedure *requires* the tenant to come to the landlord first. The tenant should not be forced to do both. The landlord must also take some risk here and cannot trifle with the tenant to see how much the tenant can fetch on the open market.

Regardless of which procedure applies, the landlord should always reimburse the tenant for the tenant's remaining improvement costs irrespective of whether the tenant secured any payment from a third party assignee or subtenant, as the price to pay for the privilege of wielding sole discretion power by means of a termination right.

§1.03 PERMITTED (NO CONSENT) TRANSACTIONS

§1.03-1 In General. There are classes of transactions which should not require the landlord's consent. Some of these are generally recognized by all landlords, others are special categories that tenants seek to include among the exempt transactions. Strictly speaking, many of these transactions have nothing to commend themselves from the landlord's viewpoint—the landlord's concerns about the control of its space and who its tenant is are simply not addressed. The only justification for them is that these are the kind of transactions that national chains get involved in; from the tenant's viewpoint, such transactions are simply too large or their significance to the internal operation of the tenant's business is too great to be interfered with by the landlord. Their importance to the large tenant overrides the concerns of the individual landlord. Many of these are carried out by larger tenants for a variety of reasons such as tax advantages or corporate convenience and have little to do with the real estate. Many are simple, invisible changes of ownership without any visible changes in the tenant's operation and are, therefore, of no consequence to the landlord. Others will result in substantial changes in who the tenant is; negotiation in these areas is more difficult.

The exempt transactions can be summarized as follows:

Affiliate Transfers (also known as Intra-Company Transfers). These are intra-mural transfers between affiliated parties, i.e., to a party which controls, is controlled by or is under common control with another party. They are effected by larger corporations for a variety of reasons, including tax advantages or corporate convenience and are universally accepted by all landlords.

Merger-Acquisition Transactions. These are mergers, consolidations and acquisitions of the tenant. They are also *generally* accepted by the landlord community although attempts to put limits on them have been made.

Multi-Store Deals. These are simply transfers of a group of stores, with a minimum of approximately three to six stores. This is an important category for the tenant but is the most difficult to negotiate.

Franchisees. These transfers are commonly accepted with certain controls and limits.

Concessionaires. These are occupants of portions of the space although they are not usually "subtenants" in the sense that a separate visible "premises" with entrances and demising walls is not carved out of the larger space. They are also generally accepted, with limits as to the total space devoted to them.

§1.03-2 Affiliate (Intra-Company) Transfers. These are the least controversial of the group. Tenants effect these intra-mural transfers usually for (i) tax or corporate convenience purposes only, or (ii) to change operational divisions within the company. The assignor-tenant is *not* released from liability under the lease and becomes a guarantor of the assignee.[24]

i. **Requirements—Same Trade name**. Some landlords impose limits such as the requirement that the trade name of the tenant not change.[25] A trade name limitation, to some degree, in connection with an affiliate transfer is acceptable so long as the lease merely requires that the tenant "comply" with the trade name clause and does not require the retention of the *same* name after the transfer. This issue will be governed by the trade name clause where tenants negotiate for a great deal of flexibility. Tenant may be entitled to change its name without the landlord's consent to a name used by the tenant or its affiliate in a certain number of its other stores. As long as the term "Tenant" remains generic and the affiliate entity can meet this requirement, then there is no problem in completing this transfer.

Where the tenant is simply assigning to an affiliate for tax advantages—for example, the transfer of all of its Massachusetts stores from one subsidiary to another—there is no change in the tenant's name or the character of its operation visible to the public; it is merely an invisible change of ownership within the corporate family. While in this particular case the requirement that the trade name remain exactly the same would not impact the tenant, it is still too restrictive of a requirement where the tenant has negotiated for greater latitude in its ability to change trade names without the landlord's consent.

Other such transfers may indeed carry with it the possibility of a change *in division* and *trade name*, which will cause a landlord some concern. For example, a landlord in an enclosed mall would not want an assignment by a fashion retailer to an affiliate that operates a discount or clearance operation under a different name. On the other hand, in a strip center or street deal, the tenant would regard such a name change to be none of the landlord's business.

So long as the tenant is only required to "comply" with the trade name clause and has secured sufficient flexibility under that clause, this condition should present no problem to it in effecting any assignment or sublease.

ii. **Same Use Clause**. This requirement is acceptable provided that the use clause itself is not "tenant-specific" or "brand specific" by name. As long as the trade name conditions are flexible and the use clause is generic, the tenant should be able to assign among its divisions. Unless the landlord has imposed a "no discount" limitation on the tenant's use or name, then even a transfer to a clearance division is conceivable.

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[24] Many tenants negotiate for their release of liability under the lease upon an assignment to an unrelated third party, provided that such third party meets certain financial criteria. However, in a transfer to an affiliate, such a provision is not appropriate.

[25] This is common in enclosed regional shopping centers. It is rare in strip centers or street deals.

iii. **Same Net Worth**. On occasion one may see a requirement that the net worth of the *assignee* <u>after</u> the transfer remains at least equal to the net worth of the *assignor* <u>before</u> the assignment. Such requirements are not well thought out in the context of an intra-mural transfer. This could only happen in an assignment from a subsidiary to a parent or to a larger, sister subsidiary company. This would not be possible in the reverse—a transfer from a parent to a subsidiary, the most common kind of intra-mural transfer. From a tenant's perspective, such net worth requirements should always be deleted.

iv. **"So Long As The Tenant Remains an Affiliate"**. Often a landlord will permit an affiliate transfer but will add the phrase "so long as such Affiliate remains an Affiliate of Tenant". This language is not necessary because the transfer by which the Tenant ceases to be an Affiliate either requires landlord's consent or it does not pursuant to the terms of the lease.

§1.03-3 <u>**Merger-Acquisition Transactions**</u>. This is a class of exempt transactions that is generally recognized by landlords but is given some scrutiny in the case of smaller companies (who seek to circumvent the assignment clause) and larger companies who engage in leveraged buy-outs and acquire a huge debt load. Landlords are also concerned about a change in the *quality* of the tenant while at the same time they recognize that they cannot significantly control these mega-transactions.

i. **Same Trade name**. Some landlords try to impose the "same trade name" requirement or, at the very least, that the trade name clause be complied with. As discussed in the subsection titled "Affiliates," above, and depending upon the tenant's ability to change the trade name without the landlord's consent, this may or may not be a problem for a tenant in a merger-acquisition transaction.

If the tenant was a large chain and was acquired by another, the impact of the "same trade name" requirement would depend on the buyer's intention. In a merger or acquisition of the tenant as a *going business* where it was intended that the chain continue to be operated under its original name, there would be no trade name change. However, if the buyer intended to change over to some other division which it owned, this requirement could impede the transaction.

So long as the requirement is that the tenant "comply" with the trade name clause (rather than agree that the name will not change at all), a tenant should not take issue with the provision. The number of stores involved will usually exceed any requirement of the trade name clause.

The conclusion is that if the trade name clause is flexible, this requirement is acceptable. If not, it must be deleted as a precondition to effect a merger-acquisition transaction.

ii. **Same Use**. Same comments as under "Affiliates" above.

iii. **Same Net Worth**. This requirement should not be acceptable to the tenant. At first blush one would think that an *acquiring* company would, after the transaction, have the same or higher net worth than before it took place. However, this is often not the case as was seen in the gold rush days of the 1980's when companies were effecting leveraged buy-outs through the vehicle of huge loans and junk bond issues. The acquiring company was then saddled with enormous debt and its net worth actually declined after the transaction.

There is also the possibility that a large public company may wish to "go private" and use a leveraged buy-out to achieve this end. In a transaction of this magnitude the tenant cannot risk jeopardizing the deal because of the refusal of a particular landlord of one location to give its consent.

As a compromise, however, the tenant can agree to some minimum net worth that will exist after the transaction. A minimum net worth of $10 million to $25 million should resolve the issue. Typically, an acquiring company could readily meet that test.

iv. **Tenant's Operation Must Be Transferred "As a Going Business"**. Although innocuous on its face, this requirement can be a very dangerous one. It is a requirement designed to ensure that the entire *business* operation of the tenant is being transferred and that not just the lease itself is being transferred to another person for the operation of *his* (i.e., the transferee's) business. It is also a disguised form of the "same trade name" requirement since a "going business" would include the name it is then operating under.

A merger-acquisition transaction may be the sale of the tenant's business to another controlling group with the intent to continue to operate under the same name or it may be a transfer of all of the tenant's store locations with the intent to operate some other business under some other name (subject, however, to compliance with the use clause and trade name clause). So long as the "Two-Step" problem is addressed, as done in the following example, the tenant cannot allow a merger-acquisition transaction to be impeded with the "going business" requirement and such requirement should be deleted.

v. **Special Problem—The "Two-Step"**. Many landlords are concerned about the situation where the tenant might employ *both* the affiliate transaction and the merger-acquisition transaction to circumvent the assignment clause completely. The transaction works this way:

> *Step One*. First the tenant assigns the single lease to an affiliate ("Little Tenant") formed for that purpose; the only asset of that affiliate is the lease itself.
>
> *Step Two*. Then the affiliate is "merged into" or "acquired" by a third party company. While the "Tenant" under the lease is technically the same, i.e., "Little Tenant," it is a single asset company now owned by a stranger. The effect is no different than a straight-out assignment of the one lease to that third party. This is a classic "change of control" transaction and the reason change of control clauses were invented.[26]

Landlords are concerned that if the affiliate exemption and merger-acquisition exemption override the change of control clause, which is a typical outcome, then the assignment clause is circumvented. The tenant can address the landlord's problem through the following provision:

> **Notwithstanding the foregoing, in the event (x) Tenant effects an Intra-Company Transfer pursuant to subparagraph (1) above to an affiliate and subsequent thereto (y) such affiliate is the subject of a Merger-Acquisition Transaction described in subparagraph (2) above, with the result that after such transaction the surviving entity would no longer be an Affiliate of Tenant, then Landlord's consent to such transaction shall be required, unless the transaction also qualified as a transaction not requiring the Landlord's consent pursuant to the other provisions of this [Assignment] Section.**

§1.03-4 Multi-Store Transaction. These are transactions that involve a relatively small number of stores. They are the situations in which the tenant is disposing of a group of stores, profitable or otherwise, to the same buyer. Obviously then, they do not necessarily involve a disposition of the entire company. In order to make these package deals easier to carry out, the tenant attempts to remove them from the landlord's control.

Certainly from the landlord's viewpoint, these deals have little to commend themselves. A landlord doesn't care if the tenant wants to sell a small group of stores where the landlord will lose all control over the premises and who the tenant is. Unlike a merger-acquisition in which the tenant is selling all of its stores and which, in the case of a national chain, involves a great many of them, a sale of a small group of stores, from the landlord's viewpoint, is hardly different from an individual assignment.

Nevertheless, it is a class of transaction which national chains engage in and they have a strong interest in avoiding the landlord's interference in the deal. If a group sale were pending and the premises were an indispensable part of the package, a refusal of the landlord to approve the transfer of the premises

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[26] Unless the lease covers the situation, a transfer of the controlling portion of the stock of a corporate tenant, where the "tenant" remains the same, is not an assignment in the classic, legal sense.

may destroy the entire transaction. Thus, one must try to arrive at a number sufficiently high to pacify the landlord while at the same time sufficiently low to remain feasible for the tenant.

i. **Number of Stores**. This is always negotiable although typically transactions of this type fall within the three to six store range. The number of stores should be expressed as an absolute number, whether tied to a geographic area or not. It should not be couched in terms of a "majority" of the tenant's stores in a particular region. A "majority" test will be unduly restrictive in an area where the tenant happens to have numerous stores. The parties must agree on a specific number of stores as the measure of what is a sufficiently large transaction to qualify for the exemption. That number will then govern in every case, regardless of whether it happens to be the majority of the tenant's stores or not.

ii. **Stores Tied to Geographic Area**. While tying the number to a geographic area is acceptable, the tenant should define a reasonable geographic area (either by reference to the State in which the premises is located or a regional area) such as:

a. **"____ of Tenant's stores in the Los Angeles - Long Beach Standard Metropolitan Statistical Area"** [or the New York City or Philadelphia metro];

b. **"____ of Tenant's stores in Northern New Jersey, being that portion of New Jersey north of the southernmost city limit of Princeton"**;

If the premises is located in a state where the tenant does not have many stores, a multi-state region may be necessary:

c. **"_____ of Tenant's stores in New England"**.

iii. **Net Worth Requirement**. Landlords try to impose a net worth requirement to ensure that the assignee has sufficient financial strength after the transaction to perform the lease obligations. As a general concept this requirement is acceptable. However, if the tenant has negotiated a release-of-liability provision, that provision will have an impact here. Even though the tenant will guarantee the performance of an assignee whose net worth is below the release requirement, the landlord is still concerned that the assignee not be in a constant state of default whereby the landlord is compelled to call upon the tenant-guarantor every month to make good on the guaranty. This is a legitimate concern. However, if the net worth requirement for *release of liability* is a certain minimum amount, then the net worth requirement necessary to permit a multi-store transaction without the landlord's consent need not be any higher than that figure. It is more important that the tenant be able to effect the transfer without the landlord's consent. To obtain that flexibility, the tenant should be willing to accept a higher release-of-liability net worth and to remain liable under the lease if that requirement is not met.

iv. **Must Be Same Buyer.** Often a landlord will require that all of the stores in the multi-store package be transferred to the *same buyer.* Although from the viewpoint of the significance of a multi-store deal, a simultaneous transfer to several buyers is just as important to the tenant as a transfer to one buyer, the landlord has the right to expect that if these transactions are going to be exempt at all, then at least they should be transfers as a group to the same buyer. That was the spirit behind the concession by the landlord; otherwise, a transfer of the premises alone to buyer "X" and 3 other stores to buyer "Y" is no different, from the landlord's perspective, than a single store assignment.

v. **Effect on Change of Control Clauses**. If there is a change of control clause in the lease, as discussed in Section 1.06, below, this transaction as well as any of the permitted transactions discussed thus far would be exempt from those change of control provisions.

§1.03-5 Franchisees. The franchising of stores is sufficiently commonplace and landlords are fairly lenient in imposing restrictions. Usually a landlord will ask for the following provisions, all of which should be acceptable to a tenant:

i. that the operation of the tenant's business or its trade name will not be changed. The landlord wants to see the tenant's name over the door, whether the tenant operates the business as a company store or through a franchisee;

ii. that the business arrangement be a *bona fide* franchise relationship, pursuant to a franchise agreement and containing operational controls by the tenant over the franchisee;

iii. that the store may not be subdivided in such a way that there are two or more separate storefronts and signs giving the appearance of separate stores; and

iv. that the tenant guarantee the performance by the franchisee, without release of liability (if the tenant assigns to the franchisee).

§1.03-6 Concessionaires. This type of arrangement is often entered into by tenants who decide that with respect to certain lines, licensees can more efficiently sell the product or the tenant may find it more profitable to market a product in this manner. The only common restrictions are the following:

i. that there be a limit on the number of concessions or amount of space devoted to such concessions. For example, a maximum of three concessions, limited in total area to 25%–30% of the premises might be acceptable; or

ii. that the store may not be subdivided in such a way that there are two or more separate storefronts and signs giving the appearance of separate stores; should be acceptable.

§1.04 SPLITTING PROFITS ON AN ASSIGNMENT OR SUBLEASE

§1.04-1 In General. A common issue in lease negotiations is the issue of a tenant retaining any real estate profits upon an assignment or sublease.[27] Although the issue does not generate as much excitement as it once did, it is still an issue of significant, albeit secondary, importance to many landlords. The chief reason the subject has waned in recent years is that (1) landlords negotiate rent increases throughout the term, (2) landlords and tenants usually agree on a 50-50 profit split, and (3) shopping center landlords are more concerned about the caliber of the assignee or subtenant and preserving the integrity and quality of their center than they are about the issue of the tenant retaining the increased market value of the lease.

A typical clause reads as follows:

"In the event (i) Tenant receives any consideration upon an assignment of this Lease, or (ii) the rent or any additional rent or charges required to be paid to Tenant by a subtenant exceeds the Minimum Rent, additional rent and other charges to by paid hereunder by Tenant to Landlord, then Tenant shall pay to Landlord all of such consideration or excess rent when received by Tenant."

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27 The term "profit" refers to the increased rental value of the property over the rent stipulated in the lease. For example, assume a tenant signed a lease in 2005 which required it to pay $50 per square foot ("psf") per annum in minimum rent. In 2009, because of rising rental values, the premises could fetch a rent of $65 psf. If the tenant were to sublet the premises to another for $65 psf, the $15 excess is referred to as the "profit" on the sublease. It is also often referred to as the "bonus value of the lease" or the "value of the leasehold estate."

In the case of a sublease, the subtenant pays the sublease rent ("subrent") to the tenant and the tenant, in turn, pays *its* rent to the landlord. The $15 psf excess amount paid by the subtenant is the profit or bonus value. In the case of an assignment, the bonus value of the lease (also called "key money" or "premium") is usually paid all at once, up-front. In theory, using the above figures, the assignee would pay to the tenant the $15 psf/year bonus value, multiplied by the number of years left on the term and then this amount would be discounted to present worth because it is being paid all at once. In practice, the key money is simply a negotiated amount, sometimes more and sometimes less than this theoretical amount.

i. **Increase in Rent Upon in Assignment or Sublease**. Some landlords try to cover all of their bases at once. The following is a typical version of such a clause:

> **"In the event Tenant shall assign its interest in this Lease or sublet the Premises, then the Minimum Rent shall be increased, effective as of the date of such assignment or subletting, to the greater of (i) the rentals payable by any such assignee or subtenant pursuant to the assignment or sublease, or (ii) an amount equal to the total of the Minimum Rent and Percentage Rent paid by Tenant for the Lease Year immediately preceding such assignment or subletting.**
>
> **In addition to the foregoing, Tenant agrees that in the event of an assignment or subletting, Tenant shall pay to Landlord any and all consideration, money or thing of value received by Tenant or payable to Tenant in connection with the transaction, except that Tenant shall not be required to pay to Landlord consideration received in connection with the sale of Tenant's trade fixtures, equipment, inventory or leasehold improvements."**

ii. **Resolution/The 50-50 Profit Split**. This issue is overwhelmingly resolved if the tenant offers to split the net profit remaining after the tenant has recovered its major costs and expenses in the deal, namely: (1) the remaining book value of its leasehold improvements, (2) any broker's commission paid to find the new tenant, (3) any alterations performed for the new tenant, and (4) attorneys' fees and other incidental costs.

§1.04-2 The 50-50 Profit Split.

i. **The Arguments Pro and Con**.

a. Landlord's Argument—"Landlord is the One in the Real Estate Business". Some landlords resent the fact that the tenant attempts to retain the profit or any portion thereof on an assignment or sublease. They argue that it is the *landlord* who is in the real estate business and who owns the property, not the tenant. It is disdainful to these landlords that the tenant has an expectation of keeping the increased rental value of the lease.

b. Tenant's Response.

1. *The Landlord Could Have Negotiated Rent Increases*. The most basic issue in the negotiation of a lease, other than the location itself, is the rent. The landlord is capable of ensuring that it receives the increasing rental value of the real estate by negotiating for rent increases at stated intervals during the term. Indeed, most leases are structured this way. If the landlord hasn't protected itself adequately, it cannot expect the tenant to make up for the landlord's failure by relinquishing any additional rental value over and above the negotiated rent increases.

Indeed, the common law shares this view. The lease is a species of a real estate interest. It is the division of the fee simple ownership of land into two estates: (1) an estate for years (i.e., a leasehold estate) by which the tenant holds and enjoys the benefits of the land for a specified term of years—it is a *present* possessory interest in the land held by the tenant for a specified period of time, and (2) the reversionary interest, i.e., when the lease expires, the leasehold estate is extinguished and the right to possess the land *reverts* to the landlord at that time—it is a *future* possessory interest in the land. The tenant, as the owner of the present possessory interest, has the exclusive right to retain its benefits, including the increased rental value of the leasehold estate (unless the lease provides otherwise).

Case law almost universally supports the view that unless the lease specifies who receives the profit, the bonus value belongs to the tenant. If the lease requires the landlord be reasonable upon an assignment or sublease, then it is *per se* unreasonable for the landlord to demand that the profits be paid to the landlord or to attempt to raise the rent directly. See the discussion in Section1.01, above, "Standards of Reasonable Consent."

2. *The Landlord Gets Percentage Rent.* While the landlord usually dislikes that the tenant is acting in the real estate business, the landlord must also remember that in a substantial number of retail commercial leases in shopping centers, the tenant agrees to, and the landlord benefits from, a percentage rent clause. So if the tenant's sales are high enough to exceed the breakpoint, the landlord shares in the gross revenues of the tenant's *retail* business. In fact, the landlord takes its cut out of the *gross receipts* of the tenant, even if the tenant suffers an operating loss for that year.

It is as if the landlord is a 5% or 6% limited partner with absolutely no investment or risk. Indeed, the percentage rent clause is one way in which the landlord *does* receive the increased rental value for the property. A good real estate location which attracts a high volume of customer traffic and sales will yield that increased value in the form of percentage rent.

3. *Tenant Assumes All of The Risks*. The landlord's argument that it should receive the increased value fails to consider the magnitude of the risk assumed by the tenant in a commercial lease. It is the *tenant* who undertakes a great deal of downside risk with very little protection. If the tenant is doing poorly and the rental value of the premises is low, the tenant gets no relief from the landlord; the tenant still must pay the minimum rent. Therefore, the tenant is thus entitled to the "upside" potential when rental values increase.

4. *No Loss To The Landlord*. Also, no one is taking money from the landlord—at best, it is a windfall caused by rising real estate values, a windfall, which traditionally (and legally) belonged to the tenant. Nevertheless, the tenant and landlord frequently share this increased rental value after the tenant first recovers its costs.

Ultimately the landlord will usually accept a 50-50 profit split. If the tenant is subletting a *portion* of the premises, all of the calculations in the following discussion are apportioned pro-rata on the basis of the square foot area subleased.

The calculation is set up in a series of arithmetical steps:

1. Consideration received from transferee less Rent paid by Tenant to Landlord = Gross Profit
2. Gross Profit less Tenants Costs = Net Profit
3. Net Profit is split 50-50 with the Landlord[28]

A more detailed breakdown of Tenant's Costs:

a. Tenant's Remaining Improvement Costs;
b. Leasing Commissions;
c. Alterations performed for assignee/subtenant
d. Other costs including attorneys' fees.

[28] <u>After</u> tenant recovers <u>100%</u> of Tenant's Costs. Some landlords insist that the parties split profit 50-50 at such time as the payments are made by the subtenant. For example, in a sublease the subtenant pays subrent monthly over the sublease term. Thus, the profit splitting calculation would be made every month, spreading out Tenant's Costs over the period of the sublease term.

§1.04-3 Discussion of The 50-50 Split.

A. Consideration less Rent = Gross Profit

Before considering sharing with landlord, tenant must determine whether there is any profit to share. This can only happen if the "consideration" the tenant receives from the assignee or subtenant is more than the Rent (i.e., everything) the tenant pays to the landlord under *its* lease.

i. **Consideration**. "Consideration" is defined as the minimum rent, additional rent and/or all other sums received by the tenant from its transferee (i.e., assignee or subtenant) *for the lease* or *for a sublease* of the premises, excluding the amount paid to the tenant by the transferee for business goodwill, merchandise, inventory, trade fixtures, business machines, furniture, other personal property of the tenant as well as all other items not representing or attributable to the value of the leasehold estate.

If the tenant is *assigning* the lease, "consideration" usually means the cash or "key money" that the assignee pays the tenant up-front for the lease. In this case, the division of profit calculation is done all at once. If the tenant is s*ubletting* the premises, the "consideration" is in the form of the subrent paid by the subtenant to the tenant throughout the term of the sublease. "Subrent" includes all minimum rent, percentage rent, CAM, taxes and other pass-throughs plus any "key money" the subtenant might also have paid.

ii. **Exclusion of Business Goodwill & Other Items Not Part of Value of Leasehold**. Amounts paid for business goodwill must be excluded from the increased rental value. The sole purpose underlying these profit clauses in landlord lease forms is to ensure that the tenant is not deriving excess profit from the landlord's real estate. These clauses are not intended to reach other funds (i.e., those unconnected to the real estate interest transferred) that may be present in a sale of a business. Thus, it is important to exclude all amounts paid for *non*-real estate portions of the deal. This is the reason for the exclusion of **"business goodwill"** and **"all other items not representing or attributable to the value of the leasehold estate".**

A landlord may argue that "business goodwill" is inherent in and attributable to the location. This is simply not the case. For example, take a prime center court location in a fashionable mall. Whether the store is occupied by the particular tenant or by a low quality operator, the rental value of that space, i.e., the rent that the landlord will charge and receive for it, is the same. The goodwill of the business is really a result of the successful operation of that business by the tenant and the good name associated with it. The goodwill of a successful national chain, as reflected in its trade name and operation, is founded upon years of consistent profitability and good management. It is not derived from the particular location. A lesser retailer occupying that space and selling its business to an assignee would command less of a price for the sale of *its* goodwill than would a successful national retailer.

It *is* true that a good real estate location which attracts a high volume of customer traffic and sales is a direct influence on the value of the lease. However, while not totally unrelated, this is sufficiently different from the *business goodwill* which flows from the successful operation of the business by the tenant. While the landlord could argue that the tenant's success was, in turn, influenced by the good real estate location, the connection is too tangential to justify including sums paid for goodwill in the equation of excess value.

iii. **Exclusion of Trade Fixtures and Merchandise**. The value of tenant's trade fixtures and merchandise must be excluded from the excess value calculation. If the tenant who is assigning or subletting is a national chain, it usually is not selling the transferee its business, i.e., its merchandise or trade fixtures.[29] More accurately, the tenant is simply selling the transferee the *location*, i.e., the right to occupy the store (with the transferee's own merchandise and fixtures). In theory, if the original tenant *did*

[29] Although it is not uncommon to do so in these types of transactions. However, if the tenant's merchandise were private label goods, the transferring tenant would not want it resold by another party under the original tenant's name.

sell the merchandise and trade fixtures, they would have to be separated out from the total consideration paid by the transferee to the tenant and excluded from the profit splitting calculation—amounts paid for merchandise and trade fixtures are not amounts paid for the real estate.

Please note, however, that part of the real estate interests that the tenant is transferring include *leasehold improvements and fixtures* (as distinguished from *trade* fixtures). Pursuant to the lease they become part of the real estate. Therefore, they become part of the profit splitting calculation. Generally speaking, leasehold improvements and "fixtures" on the one hand and "trade fixtures" on the other hand are distinguished on the basis of the degree of permanence by which they are attached to the realty. "Leasehold improvements" include, for example, walls, doors, windows, dressing rooms, bathrooms, floor covering (wood or carpet), a suspended ceiling, all electrical wiring and devices and the HVAC system. "Fixtures" include, for example, light fixtures, and bathroom fixtures (i.e., sinks, toilets). "Trade fixtures," on the other hand, include movable (or easily removable) display racks, rounders, tables, cash registers and the cash wrap or counter.

iv. **Consideration less Rent = Gross Profit**.

a. Assignments. Gross Profit is easily calculated in the case of an assignment. When the tenant assigns a lease, it assigns the obligation to pay the rents with them, and those rents remain the same. The assignee simply becomes the one who pays them to the landlord. Therefore, any money the assignee pays the tenant for the transaction is, by definition, gross profit. If, however, the tenant agreed in the lease to increase the minimum rent by some amount upon an assignment, then Gross Profit should be reduced by the amount of the increase.[30]

b. Subleases. In a sublease situation, the arithmetic becomes more complicated. Under a sublease, the original tenant continues as the "Tenant" and continues to pay all rent directly to the landlord. If the rent the tenant receives from the subtenant (subrent) is more than the rent the tenant pays to the landlord, the excess amount is Gross Profit. If the subtenant was obligated to pay the tenant percentage rent, then that percentage rent becomes part of the rent the tenant receives from the subtenant and increases Gross Profit.

However, the increase is partially offset by the following: under the definition of gross sales in the prime lease, the subtenant's gross sales are attributed to the tenant; if these "attributed" gross sales exceed the tenant's breakpoint, the tenant owes the landlord the percentage rent calculated on such excess. This increases the rent that the tenant pays to the landlord and thus Gross Profit is reduced by that amount.

c. If Rent is Increased Upon a Sublease. If the tenant stabilized or otherwise agreed to increase its minimum rent upon a sublease, then this rent increase also reduces Gross Profit by that amount. The tenant also would have a higher breakpoint because of this rent increase which serves to shelter the gross sales of the subtenant attributed to the tenant. If the subtenant's attributed gross sales exceed this higher breakpoint, the tenant will owe the landlord percentage rent calculated on the excess; this will also reduce Gross Profit.

B. Gross Profit less Tenant's Costs = Net Profit

i. **Landlord's Objection—Split Gross Profit or Net?** A principal area of dispute one will experience is whether the landlord is to receive 50% of the Gross Profit or 50% of the Net Profit.

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[30] The tenant might have agreed to "stabilize" the rent upon an assignment, i.e., increasing the minimum rent to the sum of the former minimum rent and percentage rent the tenant was paying. This is intended to protect the landlord from losing income if the tenant assigns the lease to a low volume producer. [Typically, however, the tenant would not be assigning the lease if its sales were above the specified percentage rent breakpoint.]

The landlord prefers that the tenant recovers Tenant's Costs out of the tenant's half of the Gross Profit, leaving a larger share (50% of <u>Gross</u> Profit) for the landlord.[31] This should be <u>unacceptable</u> to the tenant. It must be remembered that the basic premise here is that the bonus value of the lease belongs to the <u>tenant</u>. The tenant should be entitled to be made whole on its costs before any sharing occurs. In most cases, landlords will consent to this arrangement.

Sometimes, a landlord will insist that it also be able to recover *its* investment in the deal, for example, extra work it performed or paid for as a concession to induce the tenant into the center. To the extent the landlord has incurred costs to make the deal that are not reflected in the rent structure, it is not unreasonable to allow the landlord to recover those costs out of the Gross Profit.[32] The only question becomes: who recovers its costs first?

The combinations may vary. The best case for the tenant is as follows:

Gross Profit
less Tenant's Costs
less <u>Landlord's Costs</u>
Net Profit ÷ 2 = Landlord's share (and Tenant's share)

The landlord would like to reverse the order as follows:

Gross Profit
less Landlord's Costs
less <u>Tenant's Costs</u>
Net Profit ÷ 2 = Landlord's share (and Tenant's share)

A third way to split the profit, in true King Solomon-like fashion, is this:

Gross Profit
less 50% of Tenant's costs
less 50% of Landlord's Costs
less 50% of Tenant's Costs
less <u>50% of Landlord's Costs</u>
Net Profit ÷ 2 = Landlord's share (and Tenant's share)

The landlord would argue for a reversal of this order.

ii. **Another Problem—Landlord Demands 100% of Net Profit**. Even when the tenant is permitted to deduct its costs, many landlords still insist that <u>all</u> remaining Net Profit be paid to them. This is a short-sighted view. There will be no incentive to the tenant to try to maximize the amount it receives from a buyer. Instead, the tenant will simply ask for an amount equal to the Tenant's Costs and not a penny more; thus, there will be no Net Profit to turn over to the landlord. It is better for the landlord to agree to a 50-50 profit split to incentivize the tenant to seek the highest amount possible.

iii. **Tenant's Costs**.

a. <u>Tenant's Remaining Improvement Costs</u>. This is the amount of its *leasehold improvement costs* (<u>exclusive</u> of any construction allowance) that is still remaining on its books (i.e., yet to be depreciated) as of the effective date of the assignment or sublease.

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[31] Another area of controversy, discussed below, is where a landlord allows the tenant to deduct its costs but then insists on retaining 100% of the Net Profit remaining thereafter.

[32] On another but related subject, the landlord's payment to the tenant of a construction allowance is excluded from the calculation—see the discussion below.

1. *Depreciation*. Landlords want tenants to use the shortest useful life possible; short life equals greater depreciation taken each year equals less remaining costs to be recovered by the tenant when it assigns the lease. The tenant would normally amortize the improvements over the term of the lease. If the original term was short and had a string of options attached, the tenant would amortize over the term, including all options, or a set period of years (e.g., 12 years), whichever was less.

A tenant should always use straight-line depreciation. Some landlord lawyers prefer that tenants use the same schedule used for tax purposes (which historically permitted taxpayers to depreciate faster).[33] Current tax laws permit little or no accelerated depreciation and there is little value in pursuing this.

2. *Exclude Construction Allowance*. Since the landlord paid for a portion of the tenant's leasehold improvements in the form of the allowance, it is fair to exclude this amount from Tenant's Costs. This is automatically satisfied by the fact that the amount entered into the tenant's books is a reduction of capital investment. For example, if a store costs $1,000,000 to build and the landlord has given the tenant a $100,000 allowance, then the tenant establishes its leasehold improvement capital account at $900,000 and simply depreciates that number.[34] In drafting this clause it is best to use the phrase **"Tenant's improvement costs <u>shall exclude</u> the construction allowance paid by Landlord."** Use of the phrase "less the allowance" can result in double subtracting since the allowance has already been excluded by the tenant.

b. <u>Leasing Commissions</u>. If the tenant employed a broker to find the assignee or subtenant, this cost must be recovered. If the tenant has agreed to split profits with the landlord as-you-go along (i.e., as in a sublease), then the commission is deemed amortized over the period of the sublease.

c. <u>Alterations Performed for Assignee/Subtenant</u>. If the tenant has to perform alterations for the intended assignee or subtenant, these costs should be recovered also.

d. <u>Other Costs Including Attorneys' Fees</u>. This is intended to cover incidental costs such as attorneys' fees and other transaction costs.

§1.04-4 <u>Exemptions From Profit Splitting</u>. Profit splitting should not apply to affiliate transactions, or mergers, consolidations and acquisitions or to transactions involving more than one store of the tenant.

i. **Affiliates**. Although unlikely, it is <u>possible</u> for an affiliate to pay to the transferring tenant a premium (i.e., for tax or other purposes) for the lease or sublease. This is simply moving money around from one pocket to another. The landlord should not be involved in this transaction.

ii. **Mergers/Consolidations/Acquisitions**. The tenant would argue that the transaction is too pervasive and far-reaching for a landlord to get involved. Further, since mergers, consolidations and acquisitions are universally accepted by landlords as being no-consent transactions with which they will not interfere, this should extend to the price paid by the buyer. This figure could be enormous and driven by the actual sale of the tenant's business, i.e., its goodwill (as embodied in its name); and very little attention may be paid to the value of the lease itself.

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[33] More depreciation each year means a larger expense deduction for that year, which equals smaller taxable income, and thus, smaller tax. For this reason, the IRS wants taxpayers to depreciate leasehold improvements over the <u>longest</u> time period possible. Under present tax laws, taxpayers are left with little or no opportunity to take accelerated depreciation.

[34] It is important to remember that if a landlord gives the tenant an allowance, that amount (plus interest) is always factored into the minimum rent which continues to be paid throughout the term; thus the landlord recovers a portion of that allowance with each monthly rent payment by the tenant. Gross Profit is always reduced by the amount of rent the tenant pays (which rent includes a payback of the allowance).

iii. **More Than One Store Involved**. Other transfers involving more than one location should be exempt from profit splitting. The rationale is that in multi-store transactions, many factors enter into the purchase price for the group, many of these having nothing to do with the "bonus" value or market value of the particular lease. It would be too difficult to assign a fair portion of the price to the real estate value of the premises. However, where the landlord is persistent on the point, the parties are faced with an allocation problem. See the discussion in Section 1.04-5, below.

§1.04-5 **Computation in Multi-Store Transfer**. If more than one store is involved in the transaction it is problematic in determining how one would allocate a fair portion of the total consideration received by the tenant for the *premises.*

So long as the definition of "consideration" is narrowly restricted to the *bonus value of the real estate*, then the allocation of consideration to the premises will be that value, if any, set out in the purchase agreement between the tenant and its buyer. The difficulty is that the landlord may mistrust this number and will assume that the tenant, in its transaction, will pull value away from the premises and overvalue other stores involved in the deal in order to reduce the consideration that has to be split with this landlord.

If no allocation to each store was specifically provided for in the purchase and sale or merger agreement, then the issue will have to be negotiated with the landlord at that time, following the principle that it is the value of the *real estate interest* we are looking for, not sums paid for the sale of the business. However, if the landlord insists on some method, then there are several ways to allocate the funds. For example:

i. **Sales Per Square Foot**. Unless the tenant knows the actual value assigned to the lease and the landlord is willing to accept it, then the only other possible method the tenant could consider is to allocate the total consideration paid by the buyer for all stores in the transaction on the basis of each store's sales per square foot. The assumption is that a higher performing store contributed significantly to the determination of the total purchase price.[35]

ii. **Divide Consideration By Number of Stores in Deal**. Some landlords want to simply divide the total amount paid in the transaction by the number of stores involved. This can be very arbitrary and can either be very beneficial or very harmful to the tenant. Most of the value of the total consideration paid in a multi-store transfer may reside with one or more of the other stores involved in the deal and very little attributed to the premises. Also in a very large transaction, the individual real estate values will have less to do with the actual purchase price paid than the assets of the business itself. Simply dividing the total price by the number of stores is arbitrary and bears no relationship to the real value of the premises. In very large transactions, the tenant and its buyer may have assigned an arbitrary value to each location that might or might not be fair *in this* context. Therefore, this method should be unacceptable to a tenant.

iii. **Fair Rental Value**. Some landlords try to establish a procedure to have the fair rental value of the premises determined by arbitration and then assign that value as the "consideration" paid by the buyer for the premises. A problem with this approach is that the value may bear no relationship to the value the premises actually contributed to the tenant's deal. Although the real estate value of the premises might be high, the tenant may have been motivated by other considerations in agreeing to a total price. This is clearly illustrated in the case where the value attributed to the premises by this procedure exceeds the total consideration actually received by the tenant for all stores in the entire transaction, which then means that the other stores contributed nothing to the transaction.

[35] Whether its true or not, it is a logical assumption.

§1.05 RELEASE OF LIABILITY

§1.05-1 **__In General__**. Although greeted with much hostility by landlords, the release of liability provision is successfully negotiated by larger, national chain retailers.

i. **The Landlord's Concerns and Its Ability to Finance**. The release-of-liability issue is of major concern to the landlord to secure its receipt of the rent and the performance of the other lease obligations from the assignee-tenant. But the landlord is also concerned for another important reason: its lender will be *very* concerned if a credit tenant is released from liability under its lease upon an assignment.

ii. **Enclosed Malls**. Enclosed mall landlords are usually larger developers with many malls and thousands of tenants. They often have leases with all of the credit rated national chains and are used to heavily negotiated lease documents, some with release of liability provisions. While the particular tenant's lease will be an important credit lease for financing purposes, it is not the only one the landlord has in its portfolio of tenants. Thus, the shopping center landlord will be able to allow a release-of-liability provision in it lease if it has a sufficient amount of other credit leases without release provisions or with high release numbers.

iii. **Strip Shopping Center Deals**. Strip shopping center landlords are more entrepreneurial than enclosed mall landlords. Consequently, they are less concerned with long lease forms (endemic to enclosed malls) and to esoteric control issues such as use, trade name and operations requirements. However, it is for this same reason that issues such as the assurance in receiving the rent and the ability to finance the lease are more critical. If the tenant is a big box tenant that is a pillar of the landlord's financing, then release-of-liability will be more important to this type of landlord and its lender.

iv. **Street Deals**. Along this continuum, street deal landlords rely most heavily on the strength of the tenant's signature in feeling secure in the health of their rent stream and in their ability to finance the lease. In street deals where the tenant is often the only occupant of the building, the issue reaches critical levels with the lender and therefore, with the landlord.

v. **Release of Liability vs. Ability to Assign**. In weighing the two factors in a lease negotiation, the *ability* to assign is more important than the ability to be released upon an assignment. This does not mean that release of liability is unimportant to the tenant or not worth pursuing. Rather, a tenant should be willing to offer the landlord a greater degree of security in return for more latitude in the ability to assign.

§1.05-2 **__Financial Tests__**.

i. **Net Worth**. This is the most common and in most cases the only test that is needed. A net worth test *is* appropriate but it must relate to the ability of the tenant to pay the rentals and perform the other obligations of the lease without an inordinate risk of repeated defaults. It is irrelevant to compare it to the net worth of the original tenant, whether presently or at the time the lease was signed. The inquiry should be: "Is the proposed assignee's financial strength sufficient to perform the lease obligations?"

The number is purely a point of negotiation. The higher the magnitude of the figure, the harder it is to find an assignee that will secure the original tenant's release. But by the same token, it is also less likely that a financially strong assignee, while insufficient to release the original tenant, will default under the lease, causing the original tenant to make good on such default.

ii. **Variations of Net Worth Tests**. The parties can agree on a higher number during the first half of the term and a lower number for the second half, although for a long term lease, an escalation mechanism such as a CPI increase on the original release figure might be appropriate.

iii. **Additional Financial Tests**.

a. Current Ratio. Landlords argue that net worth numbers, by themselves, are of dubious value if most of the net worth is tied up in long term capital assets, not easily converted into cash. A current ratio is the ratio of current assets (i.e., liquid assets like cash or merchandise) over current liabilities (as distinguished from payments under long term mortgages). Accountants look to this ratio as a measure of the assignee's *liquidity.* A current ratio requirement of 1.1 to 1 would be acceptable to an assigning tenant. What this number means is that the assignee has to have $1.10 in current assets for every $1.00 of current liability.

Landlord often ask for ratios of 2 to 1 or more. In reality, however, many retailers' (especially apparel retailers') current ratios are not all that much greater on average than 1.1 to 1; those of some national chains *rarely* approach 2 to 1. The current ratio varies during the year based on inventory levels at various times and amounts then owed to vendors. Further, it is somewhat naive to assume that a soft goods retailer with a solid positive net worth would have most of its resources tied up in long term assets. Therefore, a liberal ratio, which is good for all seasons, is all that is necessary.

b. Ratio of Total Liabilities to Tangible Equity. This is a measure of how the assignee is "leveraged." A ratio of 4.5 to 1 would be acceptable to an assigning tenant. In this example, the assignee has to have $4.50 of debt for every $1 of equity.[36] The adjective "tangible" would exclude certain intangible, abstract assets such as goodwill or money paid to acquire a lease (i.e., key money).[37]

c. Credit Ratings. A release of liability test requiring as certain credit rating of the assignee should be avoided as it compounds the difficulty in finding the proper assignee. Many companies, although financially strong, do not report to these agencies or otherwise may not have a rating. Nevertheless, a careful understanding of the various rating systems is essential before a tenant should condition its release on producing an assignee that meets these requirements.

§1.05-3 **Operating History**. A test whereby the assignee must have a certain minimum number of years of operating history in the business to be conducted at the premises, with profits earned profits in most of those years, is an appropriate area for negotiation.

§1.05-4 **Tenant To Remain Liable For A Period of Time**. It is not uncommon for the original tenant to agree to remain liable on the lease, notwithstanding that the assignee has met the financial tests for release, for a given period of time to give the landlord an added measure of security. For example, agreements by the original tenant to remain liable for the first three years of the lease term or for a period of one year following the assignment are not uncommon.

§1.05-5 **Security Deposits**. Although most national chain retailers will not agree to post a security deposit when they sign the lease, it may be acceptable to do so in order to secure its release of liability upon an assignment. Whether the original tenant or its assignee is the party who posts the security deposit is purely a matter of negotiation between the tenant and his transferee.

§1.05-6 **When Tenant Is Not Released/Liability As Guarantor/Notices of Default**.

i. **Notice to Tenant**. In any situation where the original tenant is *not* released or where it continues to guarantee the assignee's performance for a limited time, the landlord should agree to notify the original tenant of a failure of performance by the assignee and to extend to the original tenant additional time to cure before a default is declared.

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[36] Assets minus liabilities = equity or net worth.

[37] Key money is booked as a capital asset (lease acquisition cost) and is depreciated over time but is considered an "intangible" asset.

Lawyers for landlords often object to any notice requirement at all, simply because they are afraid their clients will forget to send one to the tenant-assignor. Tenants are usually required to give copies of default notices to the landlord's lender all the time; it is advisable to impose the reciprocal obligation on the landlord.

ii. **Amendments/Extensions**. The original tenant's liability as guarantor must be limited to the scope of obligations as they existed when the lease was assigned. If the landlord and the assignee subsequently amend the Lease *increasing* the "Tenant's" obligations, the original tenant should not be not bound by the new obligations unless it expressly consents thereto. Although the law of suretyship may protect the original tenant in this regard (in the absence of any lease provision to the contrary), it is preferable to spell it out. Many assignment clauses in landlord lease forms actually provide that the tenant, as assignor, is bound by future amendments entered into by the assignee whether or not the tenant-assignor was consulted.[38]

iii. **Tenant Jointly and Severally Liable**. Many leases, in describing the tenant-assignor's continuing liability, state that the tenant **"shall remain jointly and severally liable"** with the assignee. This should be changed to read **"liable as guarantor".** Otherwise, the landlord can directly proceed against the tenant-assignor without even trying to recover against the assignee. The original tenant should ensure that its liability is limited to the <u>secondary</u> liability of a guarantor, not the primary liability of the assignee-in-possession.

[38] This, of course, must be deleted.

§1.06 CHANGE OF CONTROL CLAUSES

§1.06-1 __In General__. The type of transactions discussed in the foregoing sections contemplate the traditional forms of transfer—the classic assignment of the lease or the sublease of the premises, both being a conveyance of an interest in real estate. Since restraints on alienation are abhorred by the courts, it has been held that a transfer of <u>the stock</u> of a corporation is not an assignment since the "tenant" does not change—only the ownership of the tenant changes. To prevent a complete circumvention of the customary restrictions on assignment, it became customary for landlords to include such stock transfers into the definition of "assignment". Accordingly, the "change of control" clause was developed. A typical change of control clause appearing in leases generally takes the following form:

Figure 1.06-1

Change of Control

> **If Tenant is a corporation or partnership, and if at any time during the term the person or persons who, on the date of execution of this lease, own a controlling portion of such corporation's voting shares or such partnership's partnership interest, as the case may be, ceases to own a controlling portion of such shares or partnership interest, as the case may be, (whether such transfer occurs at one time or at intervals so that, in the aggregate, such a transfer shall have occurred), then any such event (herein referred to as a "Change of Control") shall be considered a "transfer" and governed by the provisions of this Article.**

§1.06-2 __Change of Control From a Tenant's Perspective—Required Exemptions__. In the case of a small, closely held, *and* non-public company it is commonly understood that the "corporate person" is the alter ego of the real owner. Hence, a transfer of the stock of such corporate "Tenant" from A to B is an assignment of the lease in all but form. However, it was immediately recognized by landlords that in the case of a public company,[39] a change of control could very likely occur as a result of day-to-day trading of shares on an exchange and it would be unfair or inappropriate to apply the clause in such a circumstance. Thus, the so-called "public company exemption" was born.

It also became apparent that such change of control clauses conflicted with a number of other commonplace transactions that were either impossible to prevent or were inappropriate for a landlord to regulate in a commercial lease. This and other developed exemptions discussed below began to illustrate that change of control clauses can only be justified in the case of the corporation or partnership that is (i) small, *and* (ii) non-public (in the case of corporations), *and* (iii) closely held. All three of these elements must be present in order for the change of control clause to be reasonable. If any one of these elements were missing, then such clauses had peculiar and unintended results and the justification for their presence in a lease vanished. Such exemptions are illustrated in Figure 1.06-2 below.

Figure 1.06-2

Change of Control Exemptions

> **"Notwithstanding the foregoing, any "Change of Control" occurring during the Term of this Lease shall not be restricted in any manner and shall not require the Landlord's consent [nor be subject to the Offer to Surrender or Recapture procedures set forth in Section 1.02 herein]:**
>
> (i) **if such transaction would have been a permitted transaction (not requiring the Landlord's consent) had the same been effected by an assignment or sublease instrument alone rather than involving a transfer of ownership interets;**

[39] *I.e.*, a company listed on a national securities exchange, including the over-counter-market.

(ii) **if the Tenant is a "public company" (i.e., a corporation, all or a portion of whose shares are listed on a stock exchange (including the over-the-counter market);**

(iii) **if the transaction is one by which Tenant becomes or ceases to be a public company;**

(iv) **any of the following transfer of shares of Tenant's corporate stock or other ownership interests: (A) any transfer made by will or intestacy; (B) any transfers to or among persons who are shareholders or owners of Tenant as of the date of this Lease or members of their families; or (C) any transfer in trust for estate planning purposes;**

(v) **where the corporation or partnership which is the "Tenant" following the transaction in question has at least ten (10) shareholders (or partners, including limited and general) and has a net worth of at least Three Million Dollars ($3,000,000.00); or**

(vi) **where such Change of Control involves any guarantor of Tenant."**

§1.06-3 <u>Exemptions – Discussion</u>.

i. **Permitted Transactions**. The transactions discussed in Section 1.03 of these materials were developed in recognition of the need for corporate tenants to effect certain transfers without the landlord's consent. [40] In addition, certain tenants may negotiate for special no-consent assignment rights.[41] All of these transfers must be preserved and exempted from the change of control clause regardless of whether they are effected by traditional assignment or sublease instruments or stock transfers, or both. And, if an offer-to-surrender clause is present in the lease, as discussed in Section 1.02, above, there would be no requirement such procedure apply in the circumstance of a change of control clause any more than they would under the traditional assignment scenarios. This is recognized in Figure 1.06-2(i) above.

ii. **Public Company Exemption**. The language in Figure 1.06-2, clause (ii), is how the phrase is drafted in most landlord lease forms. The purpose of the exemption is a recognition that the control of <u>public</u> companies could pass to others by forces the landlord cannot (and should not) control—the trading of shares on the open marketplace. However, landlords do expose themselves to some risk even by the use of this widely recognized exemption. For example, the controlling portion of the public tenant's stock may be held in the hands of a single person. That person could sell that stock to another person—the stock does not have to be offered on the floor of a stock exchange. Such a transaction would be no different from the sale of the stock of a <u>private</u> company or, quite simply, the sale of a business from one party to another. There has occurred a change of control and quite possibly, the change in the management team of the tenant. Nevertheless, even those landlords who are aware of this loophole are also aware that this is a common risk attendant with doing business with public companies.

iii. **Going Public/Going Private**. When a private company decides to go public, the landlord should have no interest in intervening in that transaction. To the extent that there is a shift in control from the original controlling parties in such a transfer (extremely unlikely), the corporation, by that very transaction, is acquiring the mantle of that which would be another exempt status—that of a public company. This exception simply eliminates any technical argument that the landlord could introduce.

During the gold rush era of the leveraged buyout, many companies used this device to "go private," i.e., to withdraw from a national securities exchange and the extensive regulation that public status entailed. Regardless of the method of financing used, the decision to go private must be reserved as the exclusive prerogative of the tenant without any interference from the landlord. As these transactions and

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[40] These include transfers to affiliates, mergers, consolidation and acquisitions.

[41] *I.e.*, the transfer of a group of stores—the "Multi-Store Transfer."

the companies involved in them are generally quite large, there is little justification in extending to the individual landlord a veto power over them insofar as they involve his location.

iv. **Transfers Within The family and Other Private Transfers**. Figure 1.06-2(iv) makes it clear that intra-family transfers of stock, including transfers to trusts, other transfers to individuals not necessarily related to the controlling party (such as long time employees), are usually non-controversial with landlords and do not trigger the clause (although control may be transferred or diluted).

v. **"Small" Companies**. As stated above, change of control clauses should not apply in the case where the company is more than a "mom and pop" operation. In most cases, the larger the company, the less the landlord relied upon the particular skills of its principals. Further, a large company which happens to be a <u>non</u>-public company may be run either (i) by a team of hired professionals where the owners are passively involved except for setting long range goals, or (ii) by a very proactive owner or owning family, who micro-manages the operations of the company to a vast extent. A landlord should not involve itself in the internal shifts of corporate control in a company of significant size, whether by stock transfer or otherwise, regardless of the personalities, backgrounds or involvement of the controlling parties. The only legitimate function of a change of control clause is to block <u>very small companies</u> from circumventing the assignment clause through the device of a stock transfer.

vi. **Change of Control of Parents or Guarantors**. Change of Control clauses, which reach vertically through corporate levels extend the landlord's intrusion into the internal affairs of the tenant. Although, the same exemptions discussed above could apply with equal force here, it is not appropriate for the landlord to immerse itself into shifts in corporate control in entities other than the original tenant and which are remote from the premises covered by the lease.

§1.06-4 <u>Changes in The "Management Team" As A Change of Control</u>. One innovative but disturbing provision that has occasionally appeared in selected landlord lease forms is the attempt to define a shift in the internal management of a company as a "change of control" and subject to the landlord's consent.

Figure 1.06—3

Continuity of Managerial Control

> **For the purposes hereof, 'effective control' shall mean a majority <u>or other substantial ownership interest in a business entity and active managerial control of the daily business operations, including (subject to voluntary delegation) all executive decisions relating thereto</u>. Without limiting the generality of the foregoing, for the purposes of this Lease, any one or more of: (i) a change in the identity of the current controlling party of the Tenant or of any business entity <u>that is the guarantor</u> of Tenant's obligations hereunder, and (ii) <u>the entering into of any management agreement or any agreement in the nature thereof, transferring control of and any substantial percentage of the profits and losses from the business operations of the Tenant in the Premises to a person or entity other than Tenant, or otherwise having substantially the same effect</u> shall be treated for all purposes as an assignment of this Lease and shall be governed by the provisions of this Section. (Emphasis added).**

i. **From A Landlord's Perspective**. The focus of a change of control should be as much centered on a <u>change in the management team</u> (whether or not it involves a stock transfer) as it is on the technical transfer of voting shares of corporate stock. In the case of a closely held corporation, a partnership, or the functional equivalent, where one or a handful of individuals runs the business from top to bottom, a straightforward change of control (that is, voting control) will usually result in a change in the management team.

In a family-owned business, however, a change of control within the family, such as from one generation to the next, may sometimes occur without an actual change of the management team. Although each case must be treated independently, most tenants would argue that mom and pop should be permitted to retire if the family business and tradition will likely be continued.

Likewise, in the case of a larger, more decentralized operation, especially a truly "public" company, the management team is the key on which the landlord (and its management team) generally base the decision to form a relationship. There are, however, many examples of very "strong" controlling parties, even in the case of public corporations, who may not be making the daily merchandising and marketing decisions, but who do choose and watch over the individuals making those choices for the company.

ii. **From A Tenant's Perspective**. These clauses go too far and represent an unwarranted intrusion into the internal affairs of a tenant and are not practical for most tenants in the context of the real world. The concept of the landlord acting in the capacity of a super board of directors having a say in the change of personnel at the most senior management levels, lest the lease be terminated for an unauthorized assignment, should be unacceptable to a tenant larger than the mom and pop size. Figure 1.06-3 would activate the landlord's participation in actions that involved management changes in the tenant *without even requiring a stock transfer* as the basis for such interference and goes even further and embroils the landlord into the very murky subject of whether and to what extent the management policies of a public company have continued following a stock transfer!

If one accepts the notion that the landlord actually relied on the particular management team of the tenant, the concept doesn't address the real situation of the differences between active and passive personalities of the controlling parties of closely held companies. Under the public company exemption, a change in the "management team" of the *private* company, whether run by a passive, non-involved owner or by a hands-on proactive owner who directs the affairs of the company down to a considerably low management level, would be subject to the landlord's consent as "an assignment" but a change of such team if it were a *public* company would not. [42] This undercuts the argument that the landlord relied on the specific management team in the first place (except in the case of the mom and pop operation). Further, the "team" upon which the landlord allegedly relied might not be controlling owners at all; rather, they simply might be highly compensated professionals and recognized experts in given area of the business. Their departure from the company should not trigger the assignment clause of a lease.

It is not suggested that the public company exemption is flawed or unsound but rather that the above examples illustrate that the change of control clause should not apply to any company other than the small, closely held and private corporation. In the case of any retailer of substantial size, management decisions are now either made by proactive hands-on owners or by a team of professionals who do not own a controlling interest in the company, or a combination of both.

[42] There are numerous real-life examples of public and private companies controlled by active or passive owners in the shopping center industry.