

Outline of Issues Concerning Assignment and Subletting

Program Material for "Critical Issues in Drafting & Negotiating Office, Retail, Industrial & Ground Leases"

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1. Silence

(a) Absent an express prohibition in a lease, a tenant has a right to assign, sublet, mortgage the leasehold interest and otherwise transfer the lease and leasehold interest.

(i) *See Berkeley Development Co. v. Great Atlantic & Pacific Tea Company*, 214 N.J. Super. 227 (Law Div. 1986).

2. Privity

(a) A landlord and tenant have both privity of estate and privity of contract.

(b) Privity of contract allows a party to enforce the other party's promises.

(c) Privity of estate only allows a party to enforce those promises that run with the land.

(i) In order for a covenant to be deemed to run with the land, the substance of the promise must touch and concern the land.

(ii) "Briefly, a promise may be said to touch and concern the land if it relates directly to the nature, quality, value, use, enjoyment, and operation of the premises." Mark A. Senn, *Commercial Real Estate Leases: Preparation, Negotiation, and Forms* (5th ed., Wolters Kluwer Law & Business), pg. 13-13 to 13-14.

(iii) Covenants or promises that have been found to run with the land and are able to be enforced by the successor in interest to a landlord include:

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- (A) Payment of rent;
 - (B) Restrictions on a tenant's right to transfer an interest;
 - (C) The obligation to pay taxes and insurance;
 - (D) The obligation to make repairs;
 - (E) Exculpatory provisions in favor of a landlord; and
 - (F) The right of a landlord to terminate a lease upon a sale of the property.
- (iv) Covenants or promises that have been found to run with the land and are able to be enforced against a landlord's successor in interest include:
- (A) A covenant of quiet enjoyment;
 - (B) A tenant's right to extend the lease term;
 - (C) A tenant's option to purchase the property; and
 - (D) A right of the tenant to prohibit a landlord from competing with the tenant.
- (d) Assignment.
- (i) Upon an assignment of a lease by a tenant, the landlord has privity of estate with the assignee.
 - (ii) Upon an assignment of a lease by a tenant, the landlord and the assignee have privity of contract only if the assignee has agreed to assume the lease agreement.
- (A) Without privity of contract, (1) the landlord cannot compel the assignee to comply with the lease provisions and (2) the assignee cannot compel the landlord to comply with the lease provisions.
- (e) Sublease.
- (i) A prime landlord and a sublessee have neither privity of estate nor privity of contract.
 - (ii) Neither a landlord nor a sublessee can enforce the lease or sublease provisions against the other.
 - (iii) A sublessee must rely on the sublessor to enforce the lease against the prime landlord.

3. Assignment vs. Sublease - Generally

- (a) Assignment - a transfer of the entire leasehold space for remainder of the term.
- (i) Note: *Assignment pro tanto* - an assignment of all rights under a lease for less than the full space.

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(b) Sublease - a transfer of less than the entire leasehold space or a transfer of less than the full term.

(i) Retention of a reversionary interest, regardless of how short, creates a sublease.

(ii) Retention of a right of re-entry upon a default is not deemed a retention of a reversionary interest.

(c) Courts will look to the substance of the transaction over the form of the transaction in the determination of whether there is a sublease or assignment.

(i) *See Berkeley Development Co. v. Great Atlantic & Pacific Tea Company*, 214 N.J. Super. 227 (Law Div. 1986).

(d) Unless otherwise provided in a lease, a transfer of ownership of an entity is neither an assignment nor a sublease. *See Posner v. Air Brakes & Equipment Corp.*, 2 N.J. Super. 187 (Ch. Div. 1948).

(e) Unless otherwise provided in a lease, a transfer by operation of law, such as a merger, is not a violation of a no assignment clause. *See Segal v. Greater Valley Terminal Corp.*, 83 N.J. Super. 120 (App. Div. 1964).

4. Competing Interests of Landlord and Tenant

(a) Will vary depending on a number of factors:

(i) Single tenant vs. multi-tenant occupancy; and

(ii) Type of Lease:

(A) Industrial;

(B) Office; and

(C) Retail.

(b) Landlord.

(i) Wants all of the benefits of the real estate.

(ii) Concern for creditworthiness of tenant/assignee/sublessee.

(iii) Concern for continuation of guaranty, if any.

(iv) Shopping Center:

(A) Tenant mix;

(B) Percentage rent;

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- (C) radius restrictions;
- (D) Anchor tenant vs. support tenant; and
- (E) Theme center - e.g., clothing outlet will not necessarily want supermarket; upscale retail not want "neighborhood store."
- (v) Use.
- (A) Impact on parking (e.g., dermatologist vs. law office).
- (B) Impact on traffic (vehicular and pedestrian).
- (C) Impact on HVAC (overtime use, data center).
- (D) Trigger applicability of Industrial Site Recovery Act or otherwise handle hazardous flammable substances that increase the level of risk.
- (E) Impact on exclusive use provisions/going dark provisions.
- (vi) Changes to physical space (which ties in with the use, alterations and restoration clauses of the lease).
- (vii) Subtenancy - some additional concerns since may involve two tenants for space (multiple signage, required alterations to accommodate two tenants, increased HVAC demand).
- (viii) Ability to accommodate growth of other tenants.
- (c) Tenant.
- (i) Flexibility to grow or contract as business demands.
- (ii) Ability to obtain revenue (via sublease) during bad economic times.
- (iii) Flexibility to sell business or merge/consolidate with parent/subsidiaries/affiliates.
- (iv) Liability protection.

5. Complete Restriction on Transfer

- (a) Typical starting point in a lease - complete restriction on occupancy by anyone other than the tenant and on transfers, including assignment, sublease, mortgage, encumbrance, license, concession, sale or transfer of stock, partnership interest or membership interest, and other transfers by operation of law.
- (i) See form attached as **Exhibit A**.
- (b) Tenant will want an agreement that Landlord, at least, will not unreasonably withhold consent to an assignment and sublease.

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(c) Tenant may also want a right, without consent, (i) to transfer (assign/sublet) to a parent, subsidiary, affiliate or purchaser of all or substantially all of its assets, (ii) to transfer by operation of law in connection with a merger or consolidation, (iii) to transfer (with respect to a service company - law firm, accounting firm, marketing firm) in connection with the admission or withdrawal of a partner, (iv) to transfer in connection with tenant "going public" and (iv) to transfer (if a family business) for purposes of succession planning or estate planning.

(d) To the extent a landlord agrees to a right of assignment or sublease without consent, the landlord should condition the validity of any transfer on landlord's receipt of an original signed assignment and assumption agreement in form and substance satisfactory to landlord.

6. Consent

(a) Majority rule, which is followed in New Jersey, provides that a landlord need not be reasonable in granting or withholding its consent.

(i) *See Jonas v. Prutau Joint Venture*, 237 N.J. Super. 137 (App. Div. 1989), *cert. den.* 121 N.J. 628 (1990).

(b) Tenant will want a landlord covenant not to unreasonably withhold, condition or delay consent.

(i) Standard of proof - what will the reasonable man do in the landlord's position.

(ii) Burden of proof rests with tenant.

(c) Some case law where a landlord agreed to not unreasonably withhold consent

(i) Landlord cannot withhold consent because a prospective subtenant is a tenant of the landlord in another building. Economic self-interest of landlord not a reasonable basis for withholding consent. *See Krieger v. Helmsley-Spear Inc.*, 62 N.J. 423 (1973).

(ii) Landlord must reasonably consider a proposed change in use, even if it violates the use clause of the lease. *See Ringwood Assoc. v. Jack's of Rt. 23, Inc.*, 153 N.J. Super. 294 (Law Div. 1977), *aff'd* 166 N.J. Super. 36 (App. Div. 1979).

(iii) A landlord's withholding consent must be tied to "the protection of the landlord in its ownership and operation of the particular property - not for its general economic protection." *Buck Consultants, Inc., v. Glenpointe Associates v. Mellon Financial Corporation*, 217 Fed. Appx. 142, 148, 2007 U.S. App. LEXIS 3016 (3d. Cir. 2007), citing *Krieger v. Helmsley-Spear Inc.*, 62 N.J. 423 (1973).

(d) *Ringwood* factors in determining whether a landlord can reasonably withhold consent.

(i) Whether the tenant-assignor will guaranty payment of rent and performance of lease covenants by the assignee.

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(ii) Financial solvency of proposed assignee.

(iii) Nature of business of proposed assignee.

(iv) Suitability of proposed assignee's business for demised premises.

(v) Necessity for altering demised premises to accommodate proposed assignee's business.

(e) Landlord should list factors it may consider **in its judgment** in evaluating a request for consent, which should include, by way of example, and which, if found present, are deemed to make a landlord's determination to withhold consent, per se reasonable:

(i) Whether the proposed assignee has adequate financial strength and experience.

(A) Tenant will want to know that the financial strength of the proposed assignee is compared with its own financial position - that landlord not seek to better its position (and then the issue will turn on the date for measurement - i.e., lease commencement or assignment). Tenant may also want to take issue with this requirement generally if tenant is required to remain liable for payment/performance under the lease.

(ii) Whether the proposed assignee's business operations are of comparable quality to the business operations of tenant and are consistent with the character of the property/building.

(A) Tenant will want to have some flexibility so long as the character of the business is consistent with the character of the property and other tenants.

(iii) Whether the proposed assignee's use is consistent with the use clause of the lease or would otherwise place landlord in default of another lease (e.g., an exclusive use provision of another tenant's lease).

(iv) Whether the proposed assignee's use will trigger the applicability of the Industrial Site Recovery Act or otherwise involves the use, handling, storage or disposal of hazardous substances or flammable substances.

(v) Whether the proposed assignee's business/operations will increase the cost of building operations (e.g., HVAC demand/security demand), trigger compliance with law requirements/costs (e.g., ADA compliance), increase the cost of building restoration, or increase traffic flow (pedestrian/vehicular).

(A) Tenant will want to be able to address by having a right to pay the additional costs or secure restoration.

(vi) Whether the proposed assignee or any affiliated entity is a tenant of landlord at the property or other property of landlord or its affiliated entities.

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(A) Tenant will want to limit this to a prospect that landlord actually had negotiations with within a stated period of time and pertaining to the property or other property in a stated radius of the property.

(vii) Whether the proposed assignee is a governmental authority or agency.

(viii) Whether the transaction would violate or otherwise require the prior consent of a ground lessor or mortgagee.

(ix) In the event that the lease is guaranteed, whether the guarantor's consent is required/granted for the proposed transaction and continuation of the guaranty.

(f) Landlord should place pre-conditions on its obligation to consider a request for consent.

(i) Tenant not in default under the lease.

(ii) Proposed assignee (and related affiliates) not a current tenant of landlord or a landlord affiliate.

(iii) Any request must be in writing.

(iv) Tenant to remain primarily liable, jointly and severally, with the proposed assignee.

(A) Landlord should make it clear that tenant - assignor is not entitled to profits from reletting of demised premises in the case of an assignee default. *See N.J. Industrial Properties, Inc. v. Y.C.&V.L., Inc.*, 100 N.J. 432 (1985).

(B) Landlord also should make it clear that the proposed assignee assumes the entirety of the lease responsibility.

(1) Most assignees only want to assume responsibility from the date of assignment.

(2) A tenant, particularly if it is being called upon to remain primarily liable, jointly and severally, with the proposed assignee, will want an agreement from the landlord (in order to facilitate its assignment transaction) that the proposed assignee's liability begins on the date of assignment.

(v) Fees.

(A) Landlord will want to be reimbursed legal fees in connection with the transaction.

(B) Landlord may want to be paid an administrative fee for reviewing a request for consent. Some leases provide that the tenant must pay an administrative fee of \$1,000 - \$1,500 that must be sent along with the request for consent.

(vi) Landlord shall not have liability to a broker for a commission.

(A) A landlord needs to review carefully any exclusive brokerage agreement it may have entered into to ensure that the broker does not have a claim to a commission for any lease transaction involving the property, thus extending to the assignment/sublease transaction.

(g) A request for consent should include:

(i) The name, address, ownership and contact individual for the proposed assignee/sublessee;

(ii) Information concerning other locations of operation;

(iii) A detailed statement of business operations, including hours of operation and nature of products/substances handled or stored;

(iv) Whether any products/substances handled or stored are hazardous or flammable;

(v) Whether the proposed assignee/sublessee is a governmental authority or agency.

(vi) Financial statements;

(vii) Banking references;

(viii) A detailed disclosure of the proposed assignee's business experience in general and in particular in the area of intended operations; and

(ix) A detailed disclosure of the financial terms of the assignment or sublease, as the case may be, and a copy of the sublease, in the event of a sublease.

(A) A tenant will not want to be forced to negotiate an agreement before it has secured the landlord's consent since neither the tenant nor the proposed sublessee will want to incur the time or cost of negotiating a transaction document if the landlord will want to recapture the space or will not consent.

(h) Landlord should provide that a grant of consent is not deemed a grant for any future transaction.

(i) A tenant will (A) want to require the landlord to delineate the basis for withholding consent if it determines to do so and (B) want the landlord's consent to be deemed given if within an agreed upon timeframe the landlord does not issue a detailed denial.

(j) See form attached as **Exhibit B**.

7. Consequences of Wrongfully Withholding Consent

(a) A landlord agreement not to unreasonably withhold consent is an affirmative covenant subjecting a landlord to a damage claim in the event of a breach.

(b) Tenant remedies for landlord unreasonably withholding consent may include:

(i) Damages;

(ii) Specific performance; and

(iii) Lease termination.

(c) Some case law.

(i) Tenant entitled to damages based on lost profits on sublease and actual expenses incurred with respect to leased premises, including utilities. *See Passaic Distributors Inc. v. Sherman Company*, 386 F. Supp. 647 (1974).

(ii) Tenant entitled to terminate lease. *See Ringwood Assoc. v. Jack's of Rt. 23, Inc.*, 153 N.J. Super. 294 (Law Div. 1977), *aff'd* 166 N.J. Super. 36 (App. Div. 1979).

(d) Landlord will want to impose a limitation on remedies.

(i) Limit tenant to specific performance and, maybe, recovery of legal fees if tenant is the prevailing party.

(ii) If landlord imposes a limited set of remedies, a tenant will want a right to terminate the lease or pursue damages in the case of landlord acting in bad faith.

8. Right of Landlord to Recapture or Participate in Profits

(a) Right of recapture.

(i) A landlord will want a right to recapture space in the event of a sublease or assignment in order to take advantage of an up market.

(A) Which is why a landlord will require a detailed copy of the financial terms of the proposed assignment or sublease when asked to consent. A landlord may want to enter into a direct lease with the proposed assignee or sublessee.

(ii) A tenant will want to exclude from recapture:

(A) An assignment in connection with a sale of the business;

(B) A transfer (where a family owned business) that is done in connection with succession planning or estate planning; and

(C) A transfer done in connection with a merger/consolidation with a parent/subsidiary/affiliate.

(iii) A tenant will want reimbursement for unamortized leasehold improvements in the event of a recapture.

(b) Right to profits.

(i) A landlord will want to share in the profits of the tenant with respect to an assignment or sublease.

(ii) The question centers on what constitutes profits, as a tenant will want to exclude costs of a transaction.

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(A) Costs of a transaction need to be carefully delineated so that both parties understand its components.

(B) A tenant will want costs to include:

(1) Brokerage fees;

(2) Legal fees;

(3) Improvements to be made for the assignee/sublessee; and

(4) Remaining unamortized leasehold improvements.

(iii) Resolve when profits are to be paid and whether based on collections or payments due.

(iv) A landlord will want to provide that there cannot be any amendment that will affect profits.

9. Sublease

(a) Interest of subtenant

(i) A subtenant will want to address the following.

(A) An estoppel certificate from the prime landlord. See form attached as **Exhibit C**.

(B) A recognition agreement from the prime landlord and an SNDA from the prime landlord's lender. See form of recognition agreement attached as **Exhibit D**. A subtenant wants to know that if the tenant/sublessor defaults, the subtenant's possession will not be disturbed. Issues include under what agreement (prime lease or sublease) will landlord agree to recognize subtenant and subtenant must attorn to prime landlord. It is very important to check mortgage documents to ensure this transaction does not run afoul of any mortgage provisions, such as non-recourse carve-out provisions. In a ground lease setting, a ground landlord may want to provide that its SNDA "explodes" in the event that the ground tenant defaults and the aggregate rents from subleases do not equal at a minimum the ground rent.

(C) A right to deal directly with the landlord with respect to signage, HVAC overtime use, landlord waiver for subtenant loan transaction.

(D) A waiver of subrogation from landlord.

(E) A right to enforce terms of prime lease in name of tenant/sublessor, including audit rights.

(F) Financial viability of tenant/sublessor. Continued viability of tenant/sublessor significant if the sublease rental does not cover the full rent due under the prime lease.

(G) Restoration obligations under the prime lease, if any.

(b) Interest of prime landlord.

Published Articles (Cont.)

- (i) Collateral Assignment of Sublease for security. See form attached as **Exhibit E**.
- (ii) Insurance/Waiver of Subrogation.
- (iii) Whether the exercise of a right of sublease should affect certain tenant rights and benefits, including concessions granted to a tenant, renewal rights, purchase options, exclusives and going dark provisions.
- (iv) Termination of sublease upon rejection of the prime lease in bankruptcy. *See 380 Yorktown Food Corp. v. 380 Downing Drive*, 2012 WL 2360897 (N.Y. Sup. 2012).
- (c) Landlord has a right to pursue possession from a subtenant in a tenancy action naming both the tenant and subtenant. *See Fogel 152-158 Realty, LLC v. Sport-A-Rama Corp.*, 2013 N.J. Super. Unpub. LEXIS 2550 (Law Div. 2013).

10. Assignment

- (a) Interest of assignee.
 - (i) A proposed assignee will want to know that the lease is in good standing and that the tenant is not in default.
- (b) Interest of tenant-assignor.
 - (i) A tenant-assignor will try to secure a release from future liability under the lease. This will raise issues concerning net worth of the proposed assignee.
 - (ii) Note substantial modification of the lease with the assignee may be considered a termination of the existing lease and formation of a new lease, thus releasing the tenant-assignor from further liability. *See Morse and Hamilton Limited Partnership v. The Gourmet Bagel Company d/b/a East Coast Bagel & Deli*, 2000 Ohio App. LEXIS 4492 (2000).
- (c) Interest of landlord.
 - (i) A landlord will want the tenant and the proposed assignee to both have primary, joint and several liability.
 - (ii) Whether the exercise of a right of assignment should affect certain tenant rights, including renewal rights, purchase options and exclusives.
 - (iii) A landlord will not want to release the tenant/assignor from environmental liability.
 - (iv) When net worth becomes an issue -
 - (A) Do you look to net worth or tangible net worth - include good will or only tangible assets?

(B) Do you require a CPA certification?

(v) Continuation of existing lease guaranty.

(d) See form attached as **Exhibit F**.

11. Mitigation of damages issue

(a) If dispossess tenant – does a subtenant wanting to remain have an effect on a landlord’s obligation to mitigate damages if landlord does not allow the subtenant to remain?

Sources

Mark A. Senn, Commercial Real Estate Leases: Preparation, Negotiation, and Forms (5th ed. 2013).

1 Commercial Real Estate Transactions in New Jersey (Jack Fersko ed., 3rd ed. 2010).

Milton R. Friedman and Patrick A. Randolph, Jr., Friedman on Leases (5th ed. 2005).