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Negotiating Assignment and Sublease Provisions in Commercial Leases

Tenants often fail to add language to the lease that the landlord must act reasonably regarding a request for consent to an assignment or sublease

After leasing commercial premises, a tenant may find that it wishes to assign the lease or sublease the premises for various reasons. This may occur, for example, because of a need for more space than the existing premises provide, a desire to relocate elsewhere, a desire to downsize or discontinue the business, or a desire to sell the business.

An assignment is a transfer by a tenant of its entire interest in the lease. The tenant cannot retain some control or interest in the lease and cannot reserve a reversionary interest in the leasehold estate. A sublease is a transfer of less than the entire interest of the tenant. See *Restatement (Second) of Property* §15.1 comment i (1977).

Consent

Commercial leases invariably require the consent of the landlord to an assignment of the lease or to a sublease.

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In the absence of such a requirement, the tenant will be able to assign or sublease without the landlord's consent. See *Berkeley Development Co. v. The Great Atlantic & Pacific Tea Company*, 214 N.J. Super. 227 (Law Div. 1986).

All too often, a tenant will sign a lease requiring the consent to an assignment or sublease by the landlord, but fail to add language to the lease that the landlord shall act reasonably when the tenant requests consent to an assignment or sublease. A careful attorney will at least ensure that the landlord must act reasonably by simply including the appropriate language in the lease. The law may be ripe for change, but in the absence of such language, it appears that the landlord can arbitrarily refuse to grant consent under the current state of the law in New Jersey.

For example In *Muller v. Beck*, 94 N.J.L. 311 (Sup. Ct. 1920), a tenant vacated the premises before the end of the lease term and the landlord refused to accept the tenant's prospective tenant. The lease agreement prevented the tenant from assigning the lease without the landlord's prior consent, and the Court

held that the landlord acted in accordance. Moreover, the Court found that, under the terms of the lease, the landlord could have any reason for rejecting the tenant's proposed assignee.

In *Zucker v. Dehm*, 128 N.J.L. 435 (Sup. Ct. 1942), a tenant vacated an apartment after the landlord refused to consent to a sublessee. The lease required the landlord's written consent before the tenant could assign or sublet the apartment and, citing *Muller*, the Court found that the landlord was acting within his right under the lease. Additionally, the court noted that the landlord could refuse to accept the proposed tenant even if the refusal appeared unreasonable. (Given residential law today, this should not be relied upon in the case of a residential tenancy.)

In *Mayfair Supermarkets v. ACME Markets, Inc.*, 87-3944, 1989 WL 32122 (D.N.J. Apr. 3, 1989), a sublessor entered into a commercial lease agreement with a sublessee that was expressly conditioned on the sublessee obtaining consent from the sublessor before assigning the lease to another tenant. The sublessee proposed a prospective assignee, but the sublessor denied the assignment. The sublessee argued that there was an "implied covenant not to withhold consent unreasonably" in the lease agreement.

The District Court noted that the New Jersey Supreme Court had not addressed this issue and, relying on Appellate Division decisions, the court held that it would not infer a "covenant of reasonableness into a commercial lease" when the parties failed to include such a provision in the lease agreement and

when the language in the lease did not permit the court to make such an inference.

In *Jonas v. Prutaub Joint Venture*, 237 N.J. Super. 137 (App. Div. 1989), the Appellate Division acknowledged the growing minority national view, which requires a landlord to act "commercially reasonable" when faced with whether to accept a proposed assignee or sublessee despite the lack of an explicit clause in the lease requiring the landlord to act reasonably. The growing minority view is discussed in the American Law Reports (James C. McLoughlin, Annotation, "When Lessor May Withhold Consent Under Unqualified Provision in Lease Prohibiting Assignment or Subletting of Leased Premises Without Lessor's Consent," 21 A.L.R. 4th 188 (1983).

In *Jonas*, a landlord did not consent to a tenant's proposed assignment of a commercial lease and the lease had an express provision prohibiting subletting or assignment. While the court noted the national minority view, the court decided not to address the direct issue of whether an implicit covenant exists in a lease requiring a landlord to act commercially reasonable when presented with a prospective assignee or sublessee.

However, in a more recent case, *East Penn Sanitation, Inc. v. Grinnell Haulers, Inc.*, 294 N.J. Super. 158 (App. Div. 1996), in support of its holding in a contract case not involving a commercial or residential lease, the Appellate Division cited the prevailing rule that a landlord can unreasonably withhold consent absent a provision to the contrary.

In *East Penn*, the plaintiff entered into a contract with the defendant to dispose of the defendant's garbage, and the plaintiff argued that the defendant acted unreasonably by not agreeing to the plaintiff's proposed assignment of the contract for garbage removal. The court applied the majority rule in holding that the defendant need not act in a commercially reasonable manner when refusing to consent to a proposed assignment or sublease absent a provision to the contrary. Thus, the court held that the defendant did not breach the contract merely by rejecting the plaintiff's assignment.

Different rules may apply where the landlord is a governmental landlord. Unlike private landlords, governmental

landlords may not act arbitrarily because, as the court noted in *Rudder v. U.S.A.*, 226 F.2d 51 (D.C. Cir. 1955), the government "as landlord is still the government."

In *Rudder*, the court held that a governmental landlord acted arbitrarily in evicting tenants who refused to deny their membership in certain organizations. The court stated that a governmental landlord is "subject to the requirements of due process of law," and that "arbitrary action is not due process."

Thus, when a governmental body is a landlord, arguably, it may have to act reasonably when requested to consent to an assignment or sublease even in the absence of a clause requiring the governmental body to act reasonably. However, a contrary result was reached in *United States v. Epstein*, 27 F.Supp.2d 404 (S.D.N.Y. 1998).

In *Epstein*, the court held that a governmental landlord could arbitrarily withhold its consent to a tenant's request to sublease the premises. The court stated that the government "was entitled to withhold its consent to sublet for a good reason, a bad reason, or no reason at all." Thus, while a commercial tenant may rely upon *Rudder* in arguing that a governmental landlord cannot act arbitrarily in denying a tenant's request for an assignment or sublease, the landlord will have a colorable argument under *Epstein* that it can deny a tenant's request for an assignment or a sublease for any reason whatsoever, or no reason at all.

If a landlord has retained the discretion to withhold consent to the assignment of a tenant's lease, a tenant may still argue that the landlord must act consistently with the obligation of good faith and fair dealing. However, as pointed out in *Mayfair*, it is by no means clear that this doctrine would succeed with respect to a proposed assignment or a sublease arising under New Jersey law.

Transfer of Tenant's Interest

In some circumstances, a tenant might negotiate a clause that will permit the tenant to assign or sublease without the landlord's consent. Appropriate language can give the tenant the right to assign or sublease to a related company or to assign the lease in conjunction with

a sale of the business, e.g., sale of a retail business. The tenant may seek a clause stating that it may assign the lease to a party who shall acquire all or substantially all of its business and assets, provided that such assignee shall assume the tenant's obligations under the lease from the date of the assignment.

On the other hand, the landlord may wish to provide that the assignee shall have assets that are equal or greater than those of the tenant.

If the lease does not provide that a transfer of the stock of a corporation constitutes an "assignment," the tenant's transfer of stock to a third party has been held to not constitute an assignment under the terms of the lease. See *Posner v. Air Brakes & Equipment Corporation*, 2 N.J. Super. 187 (Ch. Div. 1948). But in *Segal v. Greater Valley Terminal Corp.*, 83 N.J. Super. 120 (App. Div. 1964), the court held that the merger of a tenant is not a breach of a covenant against assignment. A merger has been viewed as a transfer by operation of law not in breach of a covenant forbidding an assignment.

Thus, from the landlord's perspective, a clause should be included in the lease broadly defining an assignment, e.g., a transfer by operation of law, by transfer of stock or other ownership interest in an entity, or by a merger or consolidation. This issue can be addressed in the lease by specifying, for example, whether or not the tenant is permitted to assign or sublet to an entity into which the tenant may be merged or consolidated. However, in the absence of such subject being covered, the tenant may successfully argue that it is not subject to the lease provisions forbidding an assignment or requiring the landlord's consent to an assignment.

Use Clause

Tenants must also be careful that the use clause does not unduly limit the right to assign or sublease.

The tenant should seek a clause establishing that an assignment or sublease may be for a use other than the tenant's use, especially if the use clause is narrowly tailored to tenant's use. If the use clause is too narrow, it will limit the potential assignee or subtenant to the same use as the tenant.

As a practical matter, even if the landlord has a duty to act reasonably, the ability to assign or sublet may be limited by a restrictive use clause.

Recapture of the Premises

Leases often give the landlord the right to recapture the premises and cancel the lease if a tenant wishes to assign the lease or, in the case of a sublease, to recapture the portion of the premises to be sublet. This is desirable from the landlord's point of view for various reasons, including the opportunity to negotiate a lease with the prospective assignee or subtenant at a higher rent than can be obtained from the tenant under the existing lease.

Recapture may or may not be a problem for a tenant. An office tenant, for example, may not necessarily care if the landlord exercises its right to recapture. Unless the tenant has invested substantial sums in improving the premises, the tenant has no particular interest in assignment of the lease when the tenant wishes to end its occupancy and the landlord is willing to terminate the lease.

If the tenant has made substantial improvements to the premises at its expense, then the tenant may wish to assign or sublet the premises if it can obtain a higher rent than it pays to the landlord due to its improvements, thus receiving some benefit from its improvements. This assumes, of course, that the lease permits the tenant to retain some or all of the profits in the event of an assignment or sublease.

Unlike an office tenant who has not made substantial improvements to the premises, a retail store tenant who wishes to sell its business and collaterally assign the lease may be more concerned with recapture where the location is critical to its business. If the tenant cannot assign the lease, it may not be able to sell its business.

For example, a luncheonette located in an office building may primarily rely upon the office building tenants and their invitees for its business. These customers would not continue their patronage if the tenant were to move to another location. Since the value of the business is tied to the location, a recapture provision may unduly interfere with a tenant's ability to

sell its business.

Profits

Leases also should address the allocation of any profit made in the event of an assignment or sublease. The parties will have to appropriately define the term "profits."

From the landlord's perspective, the lease might state that the landlord may recapture the space in the event of the proposed assignment or sublease or, if the landlord does not elect to recapture the space, that the landlord then may receive any profits from the assignment or sublease. The landlord will argue that it is in the real estate business — unlike the tenant — and entitled to any profits from an assignment or sublease.

However, the tenant might negotiate for a split of the profits, or for all the profits, in the event of an assignment or sublease. A franchisee, for example, may start a business at a given location with the intention to sell the business once it has been built up and obtain the profits from an assignment of the lease.

Limitation of Remedies

A lease sometimes provides that the only remedy for a tenant in the event the landlord unreasonably withholds its consent (where reasonableness is required by the lease) is to obtain a declaratory judgment and injunctive relief. However, in the case of a request for an assignment or sublease, such a remedy is inadequate in most cases. By the time the tenant is able to obtain an injunction or a declaratory judgment, it is very likely that it will have lost the potential assignee or sublessee.

A tenant should try to exclude such a limited remedy. A tenant may negotiate for a clause permitting recovery of damages or the right to terminate the lease if the landlord wrongfully refuses to consent to an assignment or sublease. Damages then can be sought for the value of the lost bargain or the lease terminated upon wrongful refusal to consent.

For example, in *Ringwood Assocs., Ltd. v. Jack's of Route 23, Inc.*, 153 N.J. Super. 294 (Law Div. 1977), aff'd 166 N.J. Super. 36, 44-45 (App. Div. 1979),

the court held that a tenant had a right to terminate the lease where the landlord breached its duty under the terms of the lease to reasonably consent to an assignment. Accordingly, tenants should resist clauses in leases that limit a tenant's remedy solely to equitable relief in the case of an unreasonable refusal to consent to an assignment or sublease.

It is also important for the tenant that the lease require the landlord to respond to a request for an assignment or sublease by a date certain so that the lease is clear on its face as to when the tenant can exercise its right to seek its negotiated remedy. If the landlord has too much time to review and approve the proposed assignment or sublease, the tenant may lose the prospective assignee or subtenant.

Other Issues

Even when the landlord has to act reasonably, the facts are always relevant and the particular lease language will be a factor. Thus, a landlord may wish to condition its consent to an assignment or sublease upon satisfaction of certain conditions, such as a sound financial statement from the proposed assignee or the exclusion of certain uses.

A landlord may also insert a clause in the lease providing that it may charge the tenant for legal fees incurred in reviewing a proposed assignment or sublease. This is not unreasonable, but the tenant should ask to place a cap on the fees or require that the fees be reasonable. A landlord also may want to limit the number of subtenants.

From the tenant's perspective, a tenant may wish to provide that in the event of a sublease, the subtenants will be able to have their name on the directory or signs.

Assignment and sublease clauses in a lease must be negotiated with the particular needs of the parties in mind. The negotiating strength of the parties will be a factor, but the parties must carefully consider their future needs in negotiating such clauses. What may be important to one landlord or tenant may not be important to another.

In the end, reasonable parties should be able to achieve a fair result in which the respective rights of the parties are set forth clearly. ■