

DRAFTING TIPS

Draft Assignment Clause that Anticipates M&A Trends

Commercial real estate lease assignments might seem straightforward for both office and retail space: A tenant that wishes to leave its space finds another tenant willing to take over the space and the original tenant's lease. And, typically, the lease's assignment clause will dictate the requirements that both the new and original tenant must meet in order to do this. But don't be fooled into thinking that because the concept of an assignment is basic, your assignment clause can be as well. In fact, it's more important than ever to take a closer look at how you've been drafting the assignment clauses in your leases, and update the language in accordance with market trends and increasing mergers and acquisitions (M&A) activity.

"Assignments and sublets often present tough issues for owners and tenants," says New York attorney Sujata Yalamanchili. And recent market trends have posed additional challenges. That's because certain types of transactions necessitate additional or different assignment provisions than the standard scenario of one tenant assigning a lease to a replacement tenant. "There has been an uptick in M&A activity," notes Yalamanchili. An assignment clause can—and should—be tailored to such a scenario.

The Case for Requiring Consent

A basic requirement owners should consider drafting in all assignment clauses is consent. That's because not all tenants are created equal. The current tenant might be right for your center or building, but giving the tenant an unfettered right to choose its replacement is dangerous. The following language is an example of a typical consent right:

Model Lease Language

Tenant will not, by operation of law or otherwise, assign, mortgage, or encumber this Lease, nor sublet or permit the Demised Premises or any part thereof to be used by others without first obtaining the prior written consent of Landlord.

(continued on p. 2)

Drafting Tips

(continued from p. 1)

The consent requirement shouldn't stop there. A tenant might want to assign its space more than once, and it could argue that your initial consent to the first assignment is a waiver of your right to approve future assignments. So if you require consent, head off this argument and preserve your right to approve every assignee by incorporating this language into your clause, suggests Yalamanchili:

Model Lease Language

Consent to one assignment by Landlord will not be deemed consent to future assignments. An assignment done without consent of Landlord will be deemed to be an event of default although Landlord will be entitled to collect rent from Subtenant or Assignee without that constituting consent.

When to Consider Making Exception to Consent

When business failures were widespread during the last economic downturn, owners anticipated more assignments. And owners wanted the right to approve assignees to make sure that they wouldn't violate other tenants' exclusive use rights or other lease rights. (For example, if a clothing store in a shopping center didn't have to get the owner's consent to an assignment, it could assign its lease to, say, a restaurant that was barred by the lease of a current restaurant tenant there.)

But now with a stronger economy, investors are actively buying up smaller—or target—businesses. These M&A deals often involve the merger of two businesses that provide the same service or product, or an acquisition of your tenant by a larger corporation, so your tenant's *use* could stay the same, but it still would need to assign its lease to the *new entity* that controls it.

“Owners have caught onto that issue and are more sensitive to it,” says Yalamanchili. In such a case, you could consider forgoing the consent requirement because you know that the use and other aspects of the tenant won't change. But it's still crucial to protect yourself. Instead of a consent right, set up a new standard: a “net worth” test, Yalamanchili advises. In other words, if the assignee meets a certain minimum net worth (and meets any other criteria set by the owner), the tenant as assignor doesn't need the owner's consent.

“The issues I see usually involve the nature of the net worth test and how well-drafted the provision is,” says Yalamanchili. “For an owner, I typically provide that the assignee's net worth must be higher than the original tenant's net worth at the time of the lease signing and at the time of the lease assignment,” she notes. Yalamanchili usually defines “net worth” using plain-English versions of generally accepted accounting (GAAP) terms.

But what if financial statements for either party are missing, or one party used GAAP and the other didn't? “Another option is to specify an actual number that the assignee needs to meet and include that figure in the clause,” Yalamanchili suggests. Net worth is not the only factor you should consid-

(continued on p. 3)

Drafting Tips

(continued from p. 2)

er, though. Yalamanchili warns that a tenant might have an acceptable net worth, but it's trajectory could be going down—it's just not reflected yet in the net worth. She notes that owners could also require historical documentation that shows the company's trajectory.

There could be some pushback. Explain that the bargain made with the original tenant contemplated that you were getting X amount of financial security, and that you expect at least that from the assignee. But no matter what you decide to include in the provisions, it's important to draft it well. "Assignments can become a thorny issue and sensitive to litigation," Yalamanchili stresses.

Tie Use Clause to Assignment Clause

While an M&A deal might not mean the use of the space will change, one of the big risks concerning not requiring your consent to assign is that the assignee eventually will somehow change—after it's too late. "As an owner, you want to have the most control possible over your tenants, so even without a consent requirement, you still can address in the lease what happens if control within one of your tenants changes," says Yalamanchili.

This control is especially critical for retail leases. "The use of space is so important because of the exclusive use rights of other tenants," says Yalamanchili. "You may think that you're protected if the lease has a use clause for the tenant, but if you've agreed that your consent is waived as long as the assignment is "reasonable," you should tie the reasonable clause for consent to the use clause. That is, state that the tenant can make a reasonable assignment of the lease without consent—provided that it passes a net worth or other financial tests or requirements—but it won't be unreasonable on your part to prevent the assignment of the lease or to stop the assignee from operating in the space later, if the use at any time violates the original use clause.

"If change in use is important to you, tying the use clause and assignment clause together is important. If you don't, a court may find that the assignee has some flexibility as to use," Yalamanchili warns.

Whether you require consent to an assignment or waive consent in favor of a net worth or some other type of test designed to ensure the assignee's success, don't let the lease be silent on these points. "Silence always works against you as an owner," Yalamanchili stresses. ♦

Insider Source

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