

9-2008

Perilous Predicting

Roger Bernhardt

Golden Gate University School of Law, rbernhardt@ggu.edu

Daniel B. Bogart

Follow this and additional works at: <http://digitalcommons.law.ggu.edu/pubs>



Part of the [Property Law and Real Estate Commons](#)

Recommended Citation

Bernhardt, Roger and Bogart, Daniel B., "Perilous Predicting" (2008). *Publications*. Paper 350.
<http://digitalcommons.law.ggu.edu/pubs/350>

This Article is brought to you for free and open access by the Faculty Scholarship at GGU Law Digital Commons. It has been accepted for inclusion in Publications by an authorized administrator of GGU Law Digital Commons. For more information, please contact jfischer@ggu.edu.

September 2008

Perilous Predicting

Roger Bernhardt

Daniel B. Bogart

Introduction

After I had written a draft of this column, I became concerned whether it made any sense, so I sent it off to my colleague, Daniel Bogart, of Chapman University School of Law. Danny has coauthored with me a casebook on California Real Estate Finance and has also written a national casebook on Commercial Leasing (both published by Carolina Academic Press). I asked him to insert his reactions directly into the text, and they are shown in italics.—RB

Analysis

In *California Nat'l Bank v Woodbridge Plaza, LLC* (2008) 164 CA4th 137, 78 CR3d 561 (reported at 31 CEB Real Prop L Rep 118 (July 2008)), the plaintiff's old 25-year lease included an option to extend for an additional 10 years, at a rent that equaled "the then prevailing rate," but one that would "not exceed the latest square foot rental paid by the Bank of Irvine or successor in Woodbridge Plaza for ground floor space." Since the old Bank of Irvine space had been subdivided and was now occupied by professional offices by the time that the original lease term expired, did the rents paid by the new occupants dictate either a prevailing rate or a cap on the rent that California Bank (successor to the original tenant, Fidelity Federal) now had to pay for the next 10 years? Were those new neighbors "successors," or had the rent cap provision—like the Bank of Irvine—gone inoperative?

By upholding a new rent at \$3.00 per square foot, the court effectively rejected the two arguments that California Bank had made regarding what it should pay on renewal:

- That the new prevailing rent rate was \$2.50 per square foot; and
- That the new rent was capped at \$1.50 per square foot.

Because the latter contention occupied the court's attention, I'll start with that one.

A Successor

For purposes of the rent cap, the court of appeal had to decide who was a "successor" because the lease had failed to define that term. The parties had exercised sufficient foresight to incorporate in the lease provisions including, after the original 25-year term would expire:

- A rent-setting mechanism ("prevailing rate");
- A rent-capping mechanism (ground floor rent paid by Bank of Irvine); and
- A hedge against Bank of Irvine's leaving the scene ("or successor").

However, they had not defined whether a "successor" was:

- Whoever thereafter occupied the same space; or

- Whoever thereafter engaged in the same kind of business within the shopping center.

The court's conclusion about the meaning and intention behind the undefined reference to "successor" was that it was the business rather than the location. That is one that I think most observers would also reach, since the remaining provisions of the lease and the business purposes of the parties all appear to point in that direction. So I am not complaining about the outcome. Rather, I am more interested in wondering whether attorneys should "learn" from this decision and modify their drafting techniques accordingly.

DB: Yes, most laymen and even many lawyers would assume that the lease contract's reference to "successor" would be limited to a successor in the same business (banking). Roger is right that this was probably the intention of the parties. The economics of the lease transaction suggest that the parties wanted a "comparable" tenant to use for rent comparisons: Thus, the Bank of Irvine was used and not a doctor's office.

Still, it is not clear to me that the court was right in validating this assumption. The contract, at least as repeated in the opinion, caps rent at the rate of Bank of Irvine or its "successor." Arguably, the rental provision melds into the use of the property. If we digress to use clauses generally, we find that parties to a lease must employ explicit language to restrict uses of property. (For example, if the original S&L lease stated that the premises "shall be used for a banking facility," most courts would view this as permissive language only. Barring other language limiting assignment, the tenant could assign its lease to a massage parlor if it so chose.) Now, look at the scenario in *Woodbridge Plaza*. All this lease says is that the rent will be capped at the rate paid by the Bank of Irvine or its successor. There is nothing on the face of the lease to indicate that the actual business use of the successor matters; the word "successor," taken alone, is permissive.

To make this concrete, assume a change in facts. What if, instead of going belly up, Bank of Irvine had assigned its lease, with the landlord's permission, to an upscale accounting firm, which then occupied the entire premises? The assignment would be for the full duration of the term of the lease. We might even assume, for good measure, that the accounting firm signs an assignment and assumption agreement. I doubt seriously that this court (or any court) would have denied that the accounting firm was a "successor" to Bank of Irvine. Could the landlord really walk away from the rental cap because the "business" of the successor differed from the original Bank of Irvine?

In fact, *Woodbridge Plaza* involved a triple net lease. There were no percentage rents, and the landlord did not have to cover other large expenses sometimes associated with leasing commercial space. This limits the importance of finding a comparable business on which to base the rental cap. The only real comparable elements that should matter are that a single successor takes the whole space, subject to a triple net lease. In *Woodbridge Plaza*, the alleged "successor" was a group of tenants with an averaged rental rate. Perhaps this would have been a better basis on which to say the new tenants were not the "successor" to Bank of Irvine.

In one sense, the cap provision looks like bad drafting: Why leave a critical term indefinite so that a court can end up defining it against your client? If the original tenant really wanted its future rent capped by what a particular neighboring space paid—regardless of the business activity going on in those premises—then it should have insisted on defining "successor" accordingly.

But my observations are hindsight, and perhaps an overreaction to what happened. Had the lease included a more particularized definition of “successor,” the tenant would have won this particular case; but if, instead, the Bank of Irvine had survived and also relocated itself two doors down the street, the tenant’s feeling would be exactly the opposite. More detailed drafting in the lease would have supplied an answer to the question, but not necessarily the answer that somebody would want later on. There would not have been a lawsuit over the meaning of the lease, but that would be because the tenant’s counsel would have advised her client that it had no hope whatsoever of persuading a judge to interpret the lease clause any other way. With the “poorly” drafted provision that was actually in the lease, the tenant had at least a shot at having it construed differently, or of being in a better position to negotiate a lower rent for the renewal term.

DB: Stores, law firms, shopping malls—and, yes, even banks—go out of business. The lease contained hard-bargained provisions, including the rental cap. Each of these provisions should have occasioned the lawyer to ask, “What if?” What if Bank of Irvine no longer exists? I agree with Roger that it is unfair to ask the lawyer to insert language covering every contingency, or to anticipate every possible turn of events over the course of a long-term lease. But this provision was important and called for the lawyer to stop and ask about the consequences of failure. And yes, the bank could have just moved down the block. But the cure is not to overdraft the lease; rather, during negotiations, the attorney should explain to the tenant client (in privileged verbal and written communication) that the cap might simply lose its value based on what the Bank of Irvine does in the future. I think that it is the unpleasant surprise that often hurts the lawyer/client relationship, and not the fact that sometimes the lawyer cannot achieve the client’s desired result. On a more general note, though, I agree with Roger that there is value in leaving some terms deliberately vague. However, knowing when to be vague is an art, and it is an art that must be practiced with the client’s knowledge.

I have similar feelings about the utility of having specified whether the successor had to be an assignee, an assuming assignee, a subtenant, or just the next bank that came in. Because of the original inexactness of the term, the courts defined it, though in various ways: The trial court confined it to “legal” successors, while the appellate court broadened it to add nonassignees but kept it limited to banking businesses. Could the parties back in 1979 have truly anticipated the kind of replacement they most wanted?

DB: The fact that one tenant basically goes bust, the lease comes to an end, and the landlord rents the space under new leases to new tenants, does not create “successors.” If that were true, then every single tenant in an existing building would be a successor to every tenant who came before it in that space.

Compounding my misgivings about the wisdom of more detailed drafting is the fact that 25 years into the future may be far too distant for rational anticipation. In 1979, when this lease was written, the plaintiff tenant was Fidelity Federal Savings & Loan. Where are the S&Ls now? Would it have been wise to include lease provisions pegging the rent (or giving the power to assign or sublet, or restricting competition in the center) to another savings and loan? Conversely, if the lease had referred to a “financial institution” or “tenant engaged in similar activity,” would that have included the new mortgage loan broker who moved into one of the subdivided spaces formerly occupied by Bank of Irvine? Or a check cashing service? Or a 7–11 with an ATM machine at the front door? Does our farsightedness tell us what kind of businesses are going to exist in 2033, 25 years from now?

DB: I have shown my hand already. I do not think that any lawyer would have anticipated the S&L debacle. But lawyers carefully draft use clauses all the time, and in the process think about the future use of the property, and the building or center of which it is a part. Why assume that they cannot engage these same skills when thinking about the rental provision?

Prevailing Rate

The nature of the cap was the only issue that seems to have been argued on appeal, but the trial also involved the basic rent calculus itself. The lease said hardly anything about that—only that it was to be set “at the then prevailing rate,” a term I find even more elusive than “successor.” I am surprised that the parties did not get into an even larger fight as to that.

First, there is the question whether any component of the cap also applied to the prevailing rate formula. The rent and cap were covered by separate sentences in the lease, but the court’s cap logic—that the original tenant did not want to be at a competitive disadvantage with the neighboring bank—could also have been used to interpret the prevailing rate formula. (Indeed, I think the landlord’s expert did just that—basing his opinion of prevailing rate on what eight banks in the vicinity paid.)

Second, whether or not the formula and cap are independent concepts, they both involve the same definitional questions: Is the prevailing rate the one that prevailed among other tenants on the block, in the shopping center, or in the census tract? Or, if the yardstick is not locational, is it the rate paid by other banks, or other “like” institutions of any sort? (The landlord testified that he meant what was “paid for like space, like financial institutions in a similar area,” but that was a 25-year-old memory and might have been based on some “refreshing” by his attorney.)

DB: The use of “prevailing rate” is an invitation to a battle by expert. Perhaps we should permit the experts to duel a la Hamilton and Burr. At least the result would be clear. The use of such a broad and undefined term suggests to me that the parties deserve whatever happens. I do believe that, whatever the reader thinks about my take on the rent cap, the court should at least be consistent. Because the court held that the rent cap was dependent on the use of the comparable business (that of a bank), the prevailing rate should refer to prevailing rates for banks operating similar facilities in the locale.

The landlord’s expert combined location and activity, although in a peculiar way: On the one hand, he did not stay within the boundaries of the shopping center (as the successor clause might have prescribed); on the other hand, he did stick with the concept of banks, rather enlarging it to include other financial institutions. With no help from the lease, the expert had the latitude to make those choices, both of which probably led to a higher square foot rate. Imprecise terms in a document allow both parties to argue for their own preferred meanings, and their preferences will inevitably be based on how the math works.

The tenant’s expert’s exclusion of financial institutions from his formula was incomprehensible to me. But so was the tenant’s basic argument that the rent should go down from its current \$2.54 per square foot to \$1.54 on renewal of the lease—a position that just invited judicial rejection and perhaps illustrated the old saw about becoming pork when you act like a pig.

Who Wants What

Attitudes inevitably differ when the provision is a formula rather than a cap. When only a cap is involved, a tenant of necessity inevitably wants it to be as broadly based as possible, while a

landlord desires the exact opposite. Those certainties do not apply when there is a formula instead that can go up or down. Be careful about what you request, lest it be granted.