

NONASSIGNABILITY CLAUSES IN COMMERCIAL LEASES: WHEN IS AN ASSIGNMENT NOT AN ASSIGNMENT?

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I. Introduction

What is the scope of a non-assignability provision in a commercial lease? How specific must the non-assignability language be to cover collateral assignments for security as well as absolute present assignments of possession and use? If the lease clause expressly states only that the tenant will not assign its interest in the lease without prior notice to and approval of the landlord, is this sufficient to prevent the tenant, without complying with such notice and consent requirements, from assigning, mortgaging, or pledging its leasehold interest as collateral to a third party who provides financing to the tenant?

These questions were answered in a recent ruling by the Illinois Appellate Court in a case of first impression. While the case is a Rule 23 opinion and thus has no precedential value, its reasoning may cause landlords to take another look at the specific language contained in nonassignability provisions of commercial leases.

II. The *Stone v. Simmons* Decision

On February 2, 1999, the Illinois Appellate Court, Second District, in *Stone v. Simmons*¹, issued an unreported opinion finding that a tenant's collateral assignment of its interest in the lease to a third-party lender, as security for the loan, did not constitute a violation of the clause in the lease prohibiting assignment without the landlord's prior consent.

The litigation in *Stone v. Simmons* arose out of a dispute between two former business partners. The plaintiff, and one of the defendants, Leonard Sandberg, were joint owners of Metalex Corporation of Delaware, a Delaware corporation ("Old Metalex"), which operated a metals processing facility on property the corporation owned in Libertyville, Illinois. In 1984, Mr. Sandberg purchased the plaintiff's interest in Old Metalex, and the plaintiff in turn purchased Mr. Sandberg's interest in the Libertyville property. Old Metalex, as tenant, then entered into a "second restated lease agreement" ("lease") with the plaintiff, as landlord, for the Libertyville facility.

Pursuant to the rental provision in the lease, Old Metalex was obligated to pay to the plaintiff a "flat" annual rent, plus 50% of net rent received over base rent for the occupancy of any subleased portion of the facility. The lease also required Old Metalex to begin paying the plaintiff an additional amount of rent, based on a complicated rental-adjustment formula, commencing February 1, 1989.

The parties disagreed on the calculation of the amount of additional rent that became due under the formula, and the plaintiff filed the original lawsuit, against Mr. Old Metalex and Mr. Sandberg, in Cook County Circuit Court in 1989. The lawsuit was subsequently

transferred to the Circuit Court of Lake County after the trial court determined that the case was for forcible entry and detainer on property located in that county.

On August 1, 1989, Old Metalex transferred a portion of its interest under the lease to New Metalex, as part of a leveraged buyout transaction whereby New Metalex purchased the assets of Old Metalex, including its interest in the lease. The parties disputed whether the transfer of Old Metalex's interest in the lease to New Metalex (labeled as a "sublease agreement") as part of the transaction was a sublease, as contended by Mr. Sandberg, or an assignment as the plaintiff contended.

The transfer purported to convey the entire unexpired remainder of the lease, and Old Metalex did not retain any reversionary interest in the property.² On July 20, 1990, the sublease agreement was amended to create a reversionary interest in Old Metalex. On June 20, 1990, the plaintiff filed a new lawsuit in Circuit Court in Cook County, and voluntarily dismissed the pending lawsuit in Lake County. On January 30, 1991, the Cook County trial court, in response to a motion to transfer by Mr. Sandberg, transferred the case to Lake County.

The plaintiff amended his complaint on May 30, 1991 to state the following causes of action and requests for relief: a declaratory judgment that Old Metalex was in default under the lease for failing to obtain the written consent of the plaintiff to the assignment of the lease from Old Metalex to New Metalex; a declaratory judgment that the collateral assignment of the lease to Continental (which had loaned New Metalex \$6 million as part of the leveraged buyout transaction) without the plaintiff's consent violated the nonassignability provision of the lease; the right to terminate the option to purchase the property contained in the lease because of the alleged defaults; breach of contract for failure to pay rent due; the occurrence of a fraudulent conveyance resulting from the leveraged buyout transaction; conspiracy to defraud the plaintiff in his attempts to collect rent; an equitable *quantum meruit* claim for New Metalex's use and occupancy of the property; tortious interference with the lease; and recovery of the plaintiff's attorney's fees and costs.

The trial court held that the rental-adjustment clause in the lease was ambiguous and found that there had been no "meeting of the minds." The court found that Old Metalex had breached the provision in the lease that required it to pay, as additional rent, 50% of rent paid by a subtenant that was in excess of the pro-rata share of the rent owed to the plaintiff.

The trial court also ruled that a "consulting contract" entered into between Old Metalex and its subtenant was a "sham" to avoid the application of the additional-rent provision, and awarded the plaintiff \$60,000 in additional rent (one-half of the \$120,000 Mr. Sandberg received under the contract). The trial court dismissed all of the remaining counts of the plaintiff's complaint. The appellate court affirmed the judgment of the circuit court with respect to all of the foregoing issues.

III. The Claims Against Continental

Four of the eight counts in the plaintiff's complaint alleged wrongdoing by Continental. The plaintiff did not contest the trial court's dismissal of two of the counts against Continental, so that only two others were preserved on appeal. The plaintiff specifically alleged that the collateral assignment of the lease to Continental, as part of the leveraged buyout transaction by which New Metalex acquired the business of Old Metalex, breached "the clear and unambiguous anti-assignment provision found in . . . the Lease." (The operative clause in the lease stated that "Tenant shall not assign this Lease without prior notice or written consent of Lessor").

Acknowledging that this was a case of first impression in Illinois, the appellate court noted that "there is a dearth of authority in Illinois on the issue of whether a collateral assignment would violate a prohibition against, or restriction of, the assignment of lease."

The court, ruling on behalf of Continental, found persuasive the few cases that have dealt specifically with this issue. The court discussed the holding in *Chapman v. Great Western Gypsum Co.*³, where the Supreme Court of California stated that "decisions in other states where the lien theory of mortgages prevails clearly hold that a covenant against assignment is not violated by the giving of a mortgage."⁴

The court in *Chapman* noted that a covenant limiting the free alienability of property must be strictly construed, and held that only a "technical" assignment, i.e., an assignment that actually transfers present title to the mortgaged property, would be prohibited by such a covenant. The *Chapman* court further ruled that in a lien theory state such as California, merely recording a mortgage against the property transfers no title to the real property.⁵

The court also cited *City of Gainesville v. Charter Leasing Corp.*⁶, where the Florida Appellate Court held that a mortgage would not violate a clause against assignment. The court in *City of Gainesville* found that in a lien theory state such as Florida, a mortgage on the leased property was not, under the terms of the lease, a "sublease, transfer or assignment by the lessee of this lease or any . . . interest herein"; rather, it is a "species of intangible property" that creates a lien on the land but is not an interest in the land.

The appellate court, in *Stone v. Simmons*, stated that "[a] true assignment of an interest in property divests the assignor of her of his entire interest in the property, but a 'collateral' assignment is instead a grant of a lien as additional security for the mortgage loan," citing *M. Ecker & Co. v. LaSalle National Bank*⁷. In *M. Ecker & Co.*, the Illinois Appellate Court had noted that in a lien theory state such as Illinois, a "collateral" assignment of rents is not a present assignment of rents, but instead is a grant of a lien as additional security for the mortgage loan. This is so, the *M. Ecker & Co.* court held, even if the assignment-of-rents provision is labeled as an "absolute" assignment, where the mortgagor retains the right to receive the rents until a default occurs under the loan documents and the assignment-of-rents clause was granted as additional security for the mortgage.⁸

The appellate court upheld the ruling of the trial court that Continental's security interest in the lease was in fact a collateral assignment, and found that the assignment did not provide Continental with possession of the property unless and until a default occurred under the loan. The appellate court also noted that the language in the assignment-of-rents provision of the lease did not specifically prohibit collateral assignments without the landlord's written permission, and stated that collateral assignments are "different in kind" from present assignments of title.

Continental's attorneys also asserted that the collateral assignment of the Lease to it actually created additional benefits for the plaintiff. This was so, they argued, because of the possibility that not only Old Metalex and New Metalex, but also Continental, could be responsible for future rental payments if it enforced its rights and remedies under the collateral assignment to protect its security interest.

The appellate court also agreed with the holding of the trial court that the plaintiff had failed to provide sufficient facts to support its claim that Continental (or the other defendants) had participated in a fraudulent conveyance regarding the leveraged buyout of Old Metalex's assets. The court found that the alleged acts complained of did not constitute either "fraud in fact" or "fraud in law."⁹

The court also found that adequate consideration existed, because Continental had in fact loaned \$6 million to New Metalex.¹⁰ Continental's attorneys noted in their appellate brief that New Metalex had paid the entire proceeds of the loan to Old Metalex in return for the assets of Old Metalex (including its rights under the Lease). Continental's attorneys also argued that Continental was not a party to, nor even aware of, the transaction that was the basis for the alleged fraudulent transaction, i.e., the subsequent diversion and transfer of the \$6 million from Old Metalex to Mr. Sandberg without adequate consideration.¹¹

IV. Lessons for Landlords (and Lenders)

The holding of the appellate court in *Stone v. Simmons* should not be seen as shocking or misguided. The law (although certainly not extensive) in other jurisdictions, and in scholarly journals and treatises, generally supports the court's analysis and ruling. As pointed out by Continental's attorneys in their appellate brief, the Restatement (Second) of Property (Landlord and Tenant), states as follows: "[I]n jurisdictions which regard the execution of a mortgage as establishing merely a lien on the mortgaged interest ('lien states'), the settled position is that such execution [of a mortgage by a tenant] is not violative of a restraint on alienation."¹²

Another treatise, *Friedman on Leases*, notes that: "[a] covenant against assignment does not prevent subletting. Nor does it prevent pledging or mortgaging the lease, though the enforcement of the pledge or mortgage may vest title to the lease in a third person with the same effect as if it had been assigned."¹³

As the appellate court in *Stone v. Simmons* stated, the plaintiff could have prevented the disputed collateral assignment of the Lease by drafting the assignment-of-lease provision

to specifically cover such an event. As Continental's attorneys pointed out in their appellate brief, the following suggested language is contained in a formbook on commercial leasing:

Tenant, for itself, its heirs, distributees, executors, administrators, legal representatives, successors and assigns, covenants that it will not assign, *mortgage or encumber* this Lease, nor sublease, or permit the Premises or any part of the Premises to be used or occupied by others, without the prior written consent of Landlord in each instance, which consent may be withheld for any reason.¹⁴

The author (when formerly employed as counsel for an institutional property owner and lender) utilized the following lease provision to prohibit assignments (including collateral assignments) by the tenant:

____. **Prohibitions.** Tenant for itself, its successors and assigns, expressly covenants that is shall not by operation of law or otherwise *assign, sublet, hypothecate, pledge, encumber or mortgage this Lease, or any part thereof, or permit the Premises to be used by others* without the prior written consent of Landlord in each instance. For purposes of this Article _____, "assignment" shall be considered to include a change in the majority ownership or control of Tenant if Tenant is a partnership or privately held corporation. Any attempt by Tenant to *assign, sublet, hypothecate, pledge, encumber or mortgage* this Lease shall be null and void. The consent by Landlord to any *assignment, subletting, hypothecation, pledge, encumbrance, mortgage, or use of the Premises by others,* shall not constitute a waiver of Landlord's right to withhold its consent to any other or further *assignment, subletting, hypothecation, pledge, encumbrance, mortgage, or use of the Premises by others.* Without the prior written consent of Landlord, this Lease and the interest therein of any assignee of Tenant herein, shall not pass by operation of law or otherwise, and shall not be subject to garnishment of sale under execution in any suit or proceeding which may be brought against or by Tenant or any assignee of Tenant. The absolute and unconditional prohibitions contained in this Article _____ and Tenant's agreement thereto are material inducements to Landlord to enter into this Lease with Tenant and any breach thereof shall constitute a material default hereunder permitting Landlord to exercise

all remedies provided for herein or by law or in equity on a default by Tenant.

(Emphasis added).

V. Conclusion

The holding of the appellate court in *Stone v. Simmons*, with respect to the issue of the tenant's ability to collaterally assign the lease without the plaintiff's permission was a victory for Continental (and perhaps for tenants and lenders in general). Although the court's ruling is not surprising, it may turn out in fact to be a Pyrrhic victory.

As the court noted, "[t]he collateral assignment in the present case did not provide Continental with possession of the property, unless the loan was in default." The issue then becomes this: What happens if and when the tenant defaults under the mortgage or other security instrument and the secured creditor attempts to exercise its rights thereunder and obtain possession and control of the property? When the mortgagee actually obtains control and the right to possession, would the landlord then have the right to declare a default under the lease for violation of the clause prohibiting assignment, and prevent the mortgagee from taking possession? Would the landlord want to exercise this right if the tenant is not paying rent, or would it prefer to have the mortgagee take possession and become responsible for payment of the rent? (As noted earlier in this article, Continental's attorneys argued that the plaintiffs in *Stone v. Simmons* would obtain the benefit of Continental as an additional source of payment of the rental if it sought to enforce its security interest). These are questions that are unanswered by the holding in *Stone v. Simmons*. The best approach is to address these issues during the negotiation of a commercial lease, and carefully draft the non-assignability provision to specifically cover collateral assignments of the lease.

Endnotes

¹ No. 91-CH-125 (2nd Dist.1999)..

² On August 3, 1999, New Metalex executed a collateral assignment of the lease in favor of Continental Bank (“Continental”) as security on a loan.

³ 216 Cal. 420, 14 P.2d 758 (Cal. 1932).

⁴ *Id.* 216 Cal. at 426-27, 14 P.2d at 760-61.

⁵ *See also Kendall v. Ernest Pestana, Inc.*, 40 Cal.3d 488, 494-95, 709 P.2d 837, 840-41 (1985) (holding that restraints on alienation, such as nonassignability provisions in lease agreements, must be strictly construed, especially “where the restraint in question is a ‘forfeiture restraint,’ under which the lessor has the option to terminate the lease if an assignment is made without his or her consent”).

⁶ 483 So. 2d 465, 467 (Fla. Dist. Ct. App. 1986).

⁷ 268 Ill. App.3d 874, 879, 645 N.E.2d 335, 339-40 (1st Dist. 1994).

⁸ *See also Board of Directors of Olde Salem Homeowners’ Association v. Secretary of Veterans Affairs*, 226 Ill. App.3d 281, 288, 589 N.E.2d 761, 766 (1st Dist. 1992), *appeal denied*, 146 Ill.2d 623, 602 N.E.2d 447 (1992) (holding that a mortgage does not convey a legal estate to the mortgagee but merely gives the mortgagee a lien on the property); *In re Cadwell’s Corners Partnership*, 174 B.R. 744, 754-55 (Bankr. N.D. Ill. 1994) (noting that Illinois is a lien theory state and that under Illinois law, the rights of the debtor in the rents and the property are not altered by the appointment of a receiver).

⁹ In *Aluminum Mills Corp. v. Citicorp North America, Inc.*, 132 B.R. 869 (N.D. Ill. 1991), the court noted that Section 4 of the Uniform Fraudulent Conveyance Act (effective in Illinois at the time of the transfer), which deals with fraudulent transfers, has been construed “as prohibiting not only ‘fraud in law’ (constructive fraud) but also ‘fraud

in fact' (intentional fraud).” The court stated that “[t]he proof requirements for finding intentional fraud under Section 548(a)(1) and fraud in fact under Section 4 are substantially the same.” *Id.* at 885. *See also General Electric Capital Corp. v. Lease Resolution Corp.*, 128 F.3d 1074, 1079 (7th Cir. 1997) (finding that the Illinois Uniform Fraudulent Transfer Act creates a an action for constructive fraud that “requires neither evidence of actual intent to defraud nor a specific misrepresentation by the defendant”); *Casey Nat’l Bank v. Roan*, 282 Ill. App.3d 55, 59, 68 N.E.2d 608, 611 (4th Dist. 1996), *appeal denied*, 169 Ill.2d 564, 675 N.E.2d 631 (1996) (holding that “[p]roof of fraud in fact requires a showing of an actual intent to hinder creditors, while fraud in law presumes a fraudulent intent when a voluntary transfer is made for no or inadequate consideration and directly impairs the rights of creditors”); *Klingman v. Levinson*, 114 F.3d 620, 626 (7th Cir. 1997) (“Illinois courts have divided fraudulent conveyance cases into the categories of fraud in fact and fraud in law. Proof of fraud in fact requires a showing of an actual intent to hinder creditors, while fraud in law presumes a fraudulent intent when a voluntary transfer is made for no or inadequate consideration and directly impairs the rights of creditors”); *Bank of Aspen v. Fox Cartage, Inc.*, 158 Ill. App.3d 939, 945, 511 N.E.2d 1234, 1236-37 (2nd Dist. 1987) (*reh’g denied* Aug. 6, 1987) (holding that a transfer supported by consideration could not have been fraudulent in law, but only fraudulent in fact, “a theory requiring the proponent to demonstrate a fraudulent intent”); *Bay State Milling Co. v. Martin (In re Martin)*, 145 B.R. 933, 946 (Bankr. N.D. Ill. 1992) (noting that a different standard of proof applies with respect to a claim of constructive fraud because “intent to defraud is presumed when the elements of constructive fraud are established”); *S.A.M. Electronics, Inc. v. Osarapasop*, No. 96 C 7402, 1998 WL

122989 (N.D. Ill. March 16, 1998) (not reported in F.Supp.) (“[i]n fraud-in-fact cases, the plaintiff must show that the defendant actually intended to hinder, delay or defraud a creditor”); *In re Liquidation of Medicare HMO, Inc.*, 294 Ill. App.3d 42, 50-52, 689 N.E.2d 374, 380-81 (1st Dist. 1997) (ruling that a plaintiff must allege the following to constitute a legally sufficient cause of action under the fraud-in-law theory: “(1) a transfer made for inadequate consideration; (2) an existing or contemplated indebtedness owed by the transferor; and (3) the transferor’s failure to retain sufficient property to repay his indebtedness,” and finding that “[i]n fraud in fact cases, since actual consideration has been given for the transfer, a specific intent to defraud must be alleged and approved”); *Gary-Wheaton Bank v. Meyer*, 130 Ill. App.3d 87, 94, 473 N.E.2d 548, 554 (2nd Dist. 1984) (holding that in fraud-in-law cases, fraud is “presumed from the circumstances” where no consideration is exchanged); *In re Telesphere Communications Inc.*, 179 B.R. 544, 556 (Bankr. N.D. Ill. 1994) (acknowledging that a constructive fraud claim can arise in the context of a leveraged buyout, but holding that to prevail the claimant must show that the transferor received less than reasonably equivalent value for the transfer).

¹⁰ The appellate court, citing *Anderson v. Ferris*, 128 Ill. App.3d 149, 153, 470 N.E.2d 518, 521 (2nd Dist. 1984), stated that “[w]here actual consideration is shown, a specific intent to defraud must be pled and proven.” Because the court found that the plaintiff had failed to do so, it dismissed the count in the complaint alleging a fraudulent conveyance by Continental and the other defendants.

¹¹ As Continental’s attorneys noted in their appellate brief, no court applying Illinois law has ever found a lender to have engaged in a fraudulent conveyance where the lender was

not a party to the leveraged buyout transaction and had no knowledge that the result of the leveraged buyout would be to defraud creditors. Continental's attorneys argued that neither event had been alleged in the plaintiff's complaint. *See Wieboldt Stores v. Schottenstein*, 94 B.R. 488, 502 (N.D. Ill. 1988) (applying federal bankruptcy law, the court ruled that in order to "collapse" a leveraged buyout consisting of a series of related transactions to which the mortgage lenders were not parties and find the lenders liable to other creditors, the plaintiffs must show that the lenders knew or intended that the loaned funds would be transferred to the shareholders of the purchased corporation); *Berland v. Mussa*, 215 B.R. 158, 169 (Bankr. N.D. Ill. 1997) (holding that even though the Illinois Uniform Fraudulent Transfer Act speaks in terms of a single transfer of property, a series of transfers may be considered together for purposes of determining whether a fraudulent transfer has occurred); *In re Telesphere Communications, Inc.*, 179 B.R. 544, 556 (Bankr. N.D. Ill. 1994) ("[c]onstructive fraud claims can also arise in the context of leveraged buyouts"); *In re Lindley*, 121 B.R. 81, 88 (B.R. N.D. Okla. 1990) (holding that where there is no direct evidence of actual intent to defraud, the court may infer this conclusion from an analysis of all of the facts and circumstances and from the presence of "the traditional 'badges of fraud'").

¹² *Restatement (Second) of Property (Landlord and Tenant)*, § 15.2 (1977) (reporter's note).

¹³ *Friedman on Leases*, § 7.303 (4th ed. 1997).

¹⁴ Mark A. Senn, *Commercial Real Estate Leases: Forms 16* (1986) (emphasis added). *See also* Martin D. Polevoy, "Assignment, Subletting and Lease Transfers," *Current Issues in Negotiating Commercial Leases 1996*, 773, 781 (PLI Handbook 1996); Linda

D. White, "Coping With Subleasing and Assignments," *Current Issues in Negotiating Commercial Leases 1996*, 809, 817-23, 829-32 (PLI Handbook 1996); Mary G. Murphy, "Assignment and Subletting," *Current Issues in Negotiating Commercial Leases 1996*, 851, 853, 856-57 (PLI Handbook 1996).