

# NEWSLETTER ARTICLE

## COMMERCIAL REAL ESTATE WORKING PAPER SERIES

### LANDLORD'S RIGHT TO RECAPTURE PREMISES

by

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#### INTRODUCTION

*In today's economic environment, numerous commercial Tenants will attempt to assign or sublet all or part of their leases and leased space (i.e. Premises). These Tenants will be attempting to mitigate loss due perhaps to a failing business, or may simply want to supplement their income by leasing part of the Premises. Landlords should be aware of their rights when a Tenant requests such a transfer of their leasehold interest.*

*This Article explains the law and process as it pertains to a Recapture Clause in a Commercial Lease. A Recapture Clause, simply stated, is a provision in a Lease that allows a Landlord to terminate the Lease and take back the Premises when a Tenant requests an assignment or sublease. This Article outlines for the reader an explanation of the recapture process, the legal issues, illustrations of existing laws, as well as the impact of those laws.*

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## **THE RECAPTURE PROCESS**

The recapture process is something that is unique to a Commercial Lease. First, there must be a Recapture Clause drafted into the Commercial Lease. The right to recapture is a contractual right. In other words, the right is something that is not given to Landlords by operation of law (i.e. automatically), but must be negotiated into the Lease. If there is no such provision, or other restriction, then the law, by default, allows a Tenant to make unrestricted transfers of their leasehold interest.<sup>2</sup>

Typically, if one exists, the Recapture Clause would be found in or around the provisions pertaining to Assignments and Subleases. This provision may be labeled in a separate subsection or simply exist directly within the language pertaining to an assignment, a sublease, or both. This right can be established with the use of some simple, relatively broad, language. Therefore, the first step is to determine whether there is in fact a Recapture Clause in the Lease.

### **TRIGGERING THE CLAUSE**

An example of a recapture provision is as follows:

*Notwithstanding any other provision of this article, Landlord, in its sole discretion, may terminate this Lease and recapture the Premises as of the date specified in any writing delivered to the Landlord by the Tenant, or its agents, indicating Tenant's intent to sublease the Premises or assign the Lease ("Notice of Intent to Transfer"); provided, Landlord delivers a written notice to Tenant within thirty (30) calendar days of receipt of said Notice of Intent to Transfer, of Landlord's intent to terminate this Lease and recapture the Premises as of the date specified in said Notice ("Recapture Notice").*

After determining whether or not some variation of the example clause above exists in a particular Lease, a Landlord should determine whether or not the Tenant has triggered the clause. A recapture provision in a Lease allows the Landlord the option to terminate the Lease early and depose the Tenant from the premises. Therefore, if the Landlord acts too early, he will subject himself to allegations of breach of Lease.

Usually, the right is activated or triggered when a Tenant provides written notice to the Landlord of its intent to assign or sublease. The following situations could constitute such notice: a letter or email from the tenant's real estate agent discussing terms of a proposed lease transfer; a sublease proposal, delivered to the landlord for its review and consideration; or a fully executed assignment between an existing tenant and a prospective tenant.

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<sup>2</sup> California Civil Code §1995.210

## APPLICABLE LAW

Recapture provisions are entirely enforceable.<sup>3</sup> In the case Carma Developers (Cal.), Inc. v. Marathon Dev. Cal., Inc.<sup>4</sup>, the California Supreme Court held that: (1) the recapture clause in a Commercial Lease under which a Landlord might terminate the entire leasehold upon Tenant's request for permission to sublet or assign all or portion of leasehold was not an unreasonable restraint on alienation under either then existing Civil Code provision or under subsequently enacted California Civil Code chapter dealing with restrictions on transfer in commercial leases; and (2) the Recapture Clause did not violate the implied covenant of good faith and fair dealing.<sup>4</sup>

In that case, the Tenant challenged the validity of a recapture provision under which the Landlord had the right to terminate the Lease on the tenant's mere request to assign or sublease.<sup>5</sup> When the Tenant notified the Landlord that he intended to sublease eighty percent (80%) of his leased space, the Landlord terminated the Lease and recaptured the entire Premises. Accordingly, the Landlord received the benefit of the increased value of the leasehold.<sup>6</sup>

The California Supreme Court held that the recapture provision was not an unreasonable restraint on alienation and that Civil Code §§1995.010-1995.270 expressly authorizes such a clause.<sup>7</sup> The Court also stated that its task is not to block business' pathway but to clear it, defining it by guideposts that are reasonably to be respected.<sup>8</sup> Moreover, the Court held that the Landlord's termination of the Lease for financial gain was not a breach of the covenant of good faith and fair dealing because it was expressly permitted by the Lease within the party's reasonable expectations.

The Court has taken the position that the freedom to contract supersedes the countervailing public policy of avoiding restrictions on the transfer of property.

## SPECIFIC LEGAL ISSUES

### **How can a Landlord legally implement a Recapture Clause?**

Because the right to recapture is a contractual right, it will be very important for the Landlord to determine and adhere to any requirements for Notices found in the Lease itself. A Recapture Notice must be sent to the Tenant, letting the Tenant know that the clause has been triggered and that the Landlord intends to take back the Property. The Lease should set forth the number of days that the Tenant is allowed to stay at the Premises before it is recaptured by the Landlord.

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<sup>3</sup> Continuing Education of the Bar, Office Leasing: Drafting and Negotiating the Lease, Ch. 24 Assignment and Subleasing, §24.36, citing Carma Developers (Cal.), Inc. v. Marathon Development California, Inc., 6 Cal.Rptr.2d 467 (Cal.,1992).

<sup>4</sup> Carma Developers (Cal.), Inc. v. Marathon Development California, Inc. 6 Cal.Rptr.2d 467 (Cal.,1992).

<sup>5</sup> Continuing Education of the Bar, Office Leasing: Drafting and Negotiating the Lease, Ch. 24 Assignment and Subleasing, §24.36.

<sup>6</sup> See *Id.* §24.36.

<sup>7</sup> See *Id.*

<sup>8</sup> See *Id.*

## **Is there a requirement that the Recapture Clause be “reasonable”?**

In some circumstances, a commercial Lease clause prohibiting a transfer of the Tenant's interest will be construed to include an implied standard of reasonableness (i.e. a Landlord may not “unreasonably withhold” consent to such a transfer).<sup>9</sup> However, an implied reasonableness condition has *no* application to an *independent* Recapture Clause in a commercial Lease.<sup>10</sup> A Recapture Clause is *not* a “transfer consent” restriction (it simply provides the Landlord with the *option* of terminating the Lease, and termination is deemed entirely different from denial of consent to assign or sublet the leasehold interest).

Whether “reasonable” or “unreasonable,” an attempted assignment or sublease of a leasehold interest (in whole or in part) by a Tenant may legally be made *subject to* the Landlord's right to *terminate* the Lease and enter into a new Lease with the intended transferee, even if exercised solely for the Landlord's financial gain.<sup>11</sup> The only restriction imposed is that a Landlord cannot allow an assignment or sublease if it is conditioned on the Landlord earning income from the transfer over and above the appreciated rental value of the new tenancy (i.e. the Landlord can receive all of the rental premium, but cannot for example, be paid a percentage of proceeds from the sale of the Tenant's business to the Assignee).<sup>12</sup>

An example of a more onerous, yet reasonable, Recapture Clause would provide that if the Tenant proposed to sublease only part of the Premises for less of the remaining term, the Landlord has the right to recapture the entire Premises for the remainder of the term. This essentially means that the Tenant loses their Lease when they intended to stay and only transfer part of the space to another Tenant.

## **IMPACT OF LAW**

The option to recapture space is an extremely important right for a commercial Landlord, regardless of the existing economic conditions. The Landlord may want the space back to satisfy an existing Tenant's needs, or for the purpose of assembling a large block of space for a potential Tenant. The Landlord may also prefer to enter into a Lease directly with the occupant of a space to avoid the issues of attornment that can arise under a sublease. Further, the Landlord could also want to recapture the space to obtain the full benefit of a transfer premium if fair market rental values have increased since inception of the original Lease.

## **ALTERNATIVES, STRATEGIES, AND CHOICES**

A right to recapture creates opportunities for the Landlord. However, because this is such a drastic remedy, the Landlord's reliance and use of this right may cause

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<sup>9</sup> California Civil Code §1995.260; The Rutter Group, a Division of Thomson Reuters/West (2008), CALANDTEN CH. 2B-5.

<sup>10</sup> The Rutter Group, a Division of Thomson Reuters/West (2008), CALANDTEN CH. 2B-5, citing Carma Developers (Cal.), Inc. v. Marathon Development California, Inc., 6 Cal.Rptr.2d 467 (Cal.,1992).

<sup>11</sup> The Rutter Group, a Division of Thomson Reuters/West (2008), CALANDTEN CH. 2B-5, citing Carma Developers (Cal.), Inc. v. Marathon Development California, Inc., 6 Cal.Rptr.2d 467 (Cal.,1992).

<sup>12</sup> The Rutter Group, a Division of Thomson Reuters/West (2008), CALANDTEN CH. 2B-5, citing Ilkchooyi v. Best 45 Cal.Rptr.2d 766, at 773 (Cal., 1995).

issues that require resolution in the future, either through negotiation, or, unfortunately, through the courts.

That said, a Landlord should consider implementing recapture provisions in all Commercial Leases. The Recapture Clause should initially be drafted as an independent provision that allows the Landlord the option of terminating the Lease or entering into a contract directly with the intended third party assignee or subtenant upon a request by a Tenant to make such a transfer. Often times, attorneys for Tenants try to remove Recapture Clauses completely from Leases. Minimally, they will attempt to restrict the types of transfers that trigger the clause to minimize the impact of the Clause. During negotiations, a variation of the Recapture Clause can be drafted that is less extreme than repossession of the Premises, which the Landlord can choose to implement in lieu of the recapture.

There are different approaches to drafting a Recapture Clause. Thus far, this Article has been discussing the approach that allows for the Landlord to have the right to recapture the entire space after the Tenant proposes a transfer. An example of a less onerous clause is the approach that allows the Landlord to simply take the proposed assignment or sublease of the space from the Tenant for the term of the proposed transfer. A Landlord may actually prefer this to a recapture in order to avoid having to obtain consent from a lender to the termination of the Lease, which occurs when the Landlord takes the property back.<sup>13</sup>

Once the Landlord has determined that the Clause has been triggered, the Landlord must always evaluate the options that the Recapture Clause provides, and determine whether to recapture the Premises or take some lesser action. The Landlord does not need to implement and enforce the clause simply because he is allowed to do so; it is only a right.

In this economic environment, a Landlord must tread lightly because a Recapture Clause is not enforceable against a Tenant in bankruptcy because the bankruptcy court has sole authority to approve the Tenant's assignments of unexpired leases *free of restrictions in the lease*.<sup>14</sup> Therefore, the Landlord will want to carefully assess whether taking certain opportunities away from the Tenant will cause them to file Bankruptcy. Overall, the Recapture Clause is an option that a Landlord should negotiate to have, but is not necessarily one that should always be implemented due to the practical and economic implications of doing so.

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<sup>13</sup> Continuing Education of the Bar, Office Leasing: Drafting and Negotiating the Lease, Ch. 24 Assignment and Subleasing, §24.36.

<sup>14</sup> The Rutter Group, a Division of Thomson Reuters/West (2008), CALANDTEN CH. 2B-5, citing 11 USC §365(f)(1).