

4. GOODWILL PAYMENTS ON ASSIGNMENT OF LEASES OF COUNCIL FACILITIES

RR 11037

Officer responsible Legal Services Manager	Author Karilyn Shutt
Corporate Plan Output: Property Asset Management	

The purpose of this report is to provide the Council with a legal opinion as to whether or not it is possible to include a clause in future leases of Council facilities to allow the Council to share in any profits derived from the assignment of those leases.

BACKGROUND

At its meeting on 22 July 1999 Council resolved to request a report from the Legal Services Manager “on the possibility of including provision in future leases of (Council) facilities to allow the Council to share in any profits derived from the assignment of such leases”. This resolution came in the context of consideration of a proposal for the assignment of the lease of the Sign of the Takahe. In that case the assignor was seeking a substantial payment by way of goodwill from the assignee. Other facilities where such issues may arise in the future, or have arisen in the past include: Beachcomber (On The Beach) Restaurant, Scarborough Fare, Mona Vale, the kiosk in the Gardens, the curator’s house in the Botanical Gardens and the New Brighton Pier terminal building.

The issue is not a new one, councillors previously had advice on this subject from Buddle Findlay in relation to capturing a share of goodwill in the event of the assignment of street stall licences. As a consequence of the advice received at that time street stall licences are now prepared on the basis that they contain a prohibition against assignment.

OPINION

Any attempt by the Council to recover a share “in any profit made by the tenant upon assignment of its lease” is unlawful, being prohibited by Section 109(1) of the Property Law Act 1952. If such a clause was to be included in Council leases, it would be unenforceable.

COMMENT

Section 109(1) of the Property Law Act states that where a lease contains a provision that the lease may not be assigned or sublet without landlord’s consent that covenant shall “be deemed to be subject to a proviso to the effect that no fine or sum of money in the nature of a fine shall be payable for or in respect of any such licence or consent; but this proviso shall not preclude the right to require the payment of a reasonable sum in respect of any legal or other expenses incurred in relation to the licence or consent”.

The effect of Section 109(1) was most recently considered by the Courts in *Chandler House Limited v Peter Mack Limited* (noted at (1988) ANZ ConvR 436). There the relevant lease provision required the assignee to pay to the landlord “one-half of any consideration given by the assignee to the lessee for the assignment of the lessee’s interest” in the lease. The clause was drawn so that it captured not only any element of goodwill but also the value of any moneys paid for lessee’s fixtures, fittings and chattels over and above their current market value. The lessee challenged the landlord’s claim on the basis that the provision contravened Section 109. The lessee’s claim was successful. Arguments that the proviso did not take effect until after consent had been given, and that the way in which the clause operated was merely a sharing of profits and was not in the nature of a “fine or sum of money in the nature of a fine”, were firmly rejected by the court.

Thorp J took the view that:

...“if the Court concludes in any case that a covenant has the effect of requiring payment of a fine or money in the nature of a fine “for or in respect” of the grant of a lessor’s consent, that must be the end of the matter, in the sense that the Court must find the covenant in breach of section 109(1) unenforceable”.

He went on to say that:

...“the term ‘fine or sum of money in the nature of a fine’ ...means nothing more than ‘paid as the price for consent’ ...[I]t seems to me unavoidable that [a requirement to pay to the Lessor one half of any consideration given by the assignee to the Lessee for the assignment] is one which requires the lessee to pay ‘a fine or sum of money in the nature of a fine for or in respect of consent to assignment.’”

As originally enacted Section 109(1) applied only “unless the lease contains an express provision to the contrary”. The Property Law Amendment Act in 1975 however removed those words and substituted a complete prohibition, “notwithstanding an express provision to the contrary”. Since 1975 therefore contracting out has not been permitted.

Notwithstanding Section 109(1) PLA there are still odd examples of provisions similar to that contained in the lease in the Chandler House case in use in Christchurch. The most obvious examples related to leases in use at Riccarton Mall and (from memory) the Triangle Centre. In those cases the particular provisions seemed to be employed to ensure appropriate tenancy mix, an issue which does not usually concern the Council.

It also needs to be remembered that in the early days of establishment of Riccarton Mall there was a strong Australian management influence. In some States in Australia a lessor can require a consideration for consent to assignment, but that is clearly not the case in New Zealand. Indeed there is Australian authority (*Barina Properties Pty Limited v Bernard Hastie (Australia) Pty Limited* [1979] 1 NSWLR 480) for the proposition that a landlord requiring an increase in rental as a condition of consent to a sublease does not constitute a fine or premium of the type that would be captured by Section 109(1) PLA. It is doubtful whether, given the firm language used in the *Chandler House case*, the Barina decision would be followed in New Zealand. Indeed the 1991 Law Commission discussion paper (which preceded its 1995 proposed redraft of the Property Law Act) made clear that the Commission favoured:

- (a) Retention of Section 109(1) in its present form.
- (b) Clarification of the wording to make it clear that an increase in rental as a term of consent to assignment should be clearly captured within the ambit of (currently) Section 109(1) PLA.

In respect of this observation however it is important not to confuse two different circumstances:

- (a) The circumstances where the landlord wishes to impose a condition to consent requiring a rent review and/or rent increase without express contractual authority to do so on the one hand; and
- (b) The circumstances where the lease provides either:
 - (i) That rental will increase from \$X to \$Z as a consequence of assignment (this most commonly occurring where a discounted rent has been provided to an original tenant); or
 - (ii) That a rent review to market rent may be undertaken at the time of assignment (which is rather rare in any event).

Section 109 would come into play under (a), but not under (b). The effectiveness of any rental adjustment provision however needs to be questioned since they attack the incoming tenant rather than the outgoing tenant. Increases in rental (for a tenant who has already paid perhaps more than the business is worth) can be very counterproductive and can often lead to unsuccessful trading by the incoming tenant.

CONCLUSION

Provisions in leases which attempt to claw back for the landlord's benefit part of the goodwill charged on an assignment are rare and, as noted above, unenforceable in any event. If the new Property Law Act is enacted in its current form (though when that will happen is unknown) the law will not change. One might imagine that vacant premises would be difficult to lease if prospective tenants knew that Council would "clip the ticket" at the time of sale. This is particularly true in respect of greenfield operations where operators may need to take significant entrepreneurial risk and work very hard to establish the new business. The point is perhaps not so pronounced in respect of other more well established facilities.

In the course of preparation of this report discussions have been held with members of the Property Unit and with Denis Sheard at Buddle Findlay. There is general agreement on the following:

- (a) Restricting the term of leases and available rights of renewal is an effective mechanism to reduce goodwill value on leases. It may however be a counterproductive exercise, reducing the financial incentives for entrepreneurial flair and sheer hard work by tenants.
- (b) Provisions can be incorporated into leases which prohibit assignment, or restrict rights of assignment and subletting in the first few years of a tenancy. A provision in a lease which, say, prohibited assignment for the first two years and required the lease to be surrendered in the circumstances of an assignment within that period is likely only to result in either:
 - (i) Council being stuck with an unsatisfactory tenant for longer than might otherwise be the case; or
 - (ii) A successful operator staying in the business until the period has elapsed; and/or
 - (iii) A black market arising for under-the-table goodwill payments. (Indeed any proposal to capture part of the goodwill payment may inevitably have this outcome.)
- (c) If Council grants startup concessions to a new tenant, then those concessions could perhaps be drafted in such a way that they become repayable in the event of assignment within a specified period of the commencement of the lease. Again however the prudent tenant will merely order his or her affairs to ensure that repayment does not arise.
- (d) Leases can be granted on terms which ensure that Council shares in some of the rewards of successful trading from the premises during the currency of the lease. This is best achieved through a percentage rent mechanism. Council has used such provisions in the past. Provided that percentage rents are ratcheted so that they cannot drop below current market rental levels then downside risk is reduced. Arguably this is the most effective and constructive way in which Council can receive a “premium” for the use for private profit purposes of buildings in public ownership.
- (e) Not all premises Council lease will be suitable to all or any of the approaches outlined above. In each case the particular solution should be developed having regard to the identity of the premises and the nature of the particular business.

Chairman’s

Recommendation: That the information be received.