

# REAL ESTATE REPORT

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## Who Are These People? Maintaining Reasonable Control of Lease Assignments & Subleases

A commercial lease can be a document of excruciating complexity. It must govern the long-term relationship of parties through periods of changing needs (i.e., expansion, contraction or relocation), changing market circumstances (utility, insurance and property tax fluctuations), and even the totally unexpected (fire, condemnation or environmental contamination).

However, at its essence, every lease is an agreement by a landlord to allow a specific tenant exclusive occupancy of all or some portion of a valued asset. The identity of the tenant is very often a defining factor in whether the landlord will agree to enter into a particular lease.

Obviously, the first criteria by which a landlord evaluates a particular tenant is credit-worthiness. A prudent landlord entering into a substantial lease will try to understand as

much about the tenant's business as would a bank preparing to make a large loan. The landlord has additional concerns associated with the image of the property and compatibility of a prospective tenant's use with other tenants. There may also be issues as to existing tenants who have contracted to exclude direct competitors from a building. The prospective tenant's track record in dealings with prior landlords may also be a key factor in the decision to lease. As a result, there is a particularly high level of concern among landlords that the identity or nature of a tenant not change without the landlord's consent.

Commercial landlords attempt to address these concerns through several lease provisions. Restrictions on the permitted use of space are typical and may be specific or quite general (i.e., "for office and related purposes"). Rules and regulations for the entire building or development may be imposed and incorporated into the lease. However, the "Assignment and Sublease"

provisions are the most potentially valuable tool for a landlord in maintaining meaningful control of its tenant base.

As an initial matter, all leases must be viewed in the context of common law, which assumes that most property rights are assignable in the absence of agreed-upon restrictions. As a result, landlords attempt to impose explicit restrictions on transfer or assignment as part of the lease. Typical lease language is: "Tenant may not assign this Lease or sublease the Premises without the prior written consent of the Landlord." (Sometimes the tenant will be successful in negotiating for an additional phrase that may assume great significance depending upon the circumstances: "which consent will not be unreasonably withheld or delayed"). Landlords often incorporate a "take back" right that permits them the option to recapture the space in lieu of permitting an assignment or sublease. A landlord cost reimbursement charge may be imposed on the tenant and it is typical that the landlord will lay claim to all or a portion of the tenant's "profits" on an assignment or sublease. Careful landlords are also quite explicit about the continuing liability of the initial tenant for all ongoing obligations under the lease. Such provisions can run on for pages in an effort to cover every possible scenario in great detail.

On the other hand, these protective provisions are often triggered only by a proposed "assignment or sublease" transaction. Depending upon the drafting of the "trigger" criteria, this may leave options open to the tenant that were never contemplated by the

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Felhaber Larson Fenlon & Vogt

# “Pay-When-Paid” Clauses: A Gateway Into the Unknown

“Pay-if-paid” or “pay-when-paid” clauses are often used in contracts between general contractors and subcontractors. The clauses usually provide that a general contractor is not required to pay a subcontractor unless and until the project owner pays the general contractor. These provisions may cause a subcontractor to suffer a significant hardship. The enforceability of the clauses varies greatly from state to state. Before a subcontractor accepts such a provision, it should understand the clause and know whether it is enforceable in its state.

## WHAT THE CLAUSE MEANS

Some general contractors have shifted the responsibility of collection to subcontractors through pay-when-paid clauses. In effect, the provision seeks to transfer from the general contractor to the subcontractor the credit risk for an owner’s non-payment. The following are two examples of such clauses:

1. “Receipt of funds by the Contractor from the Owner is a condition precedent to the Contractor’s obligation to pay Subcontractor under this Agreement, regardless of the reason for the Owner’s non-payment, whether attributable to fault of the Owner, Contractor, Subcontractor or due to any other cause.”
2. “The receipt of . . . payments by the Contractor is a condition precedent to payments to the Subcontractor.”

## TREATMENT BY THE STATES

### Clause Unenforceable

A few states have held that pay-when-paid clauses are unenforceable contract provisions. That is, even if these provisions are contained in the contract, the courts

will not allow the general contractors to enforce the provisions. The legislatures of North Carolina and Wisconsin have barred enforcing these clauses entirely. Similarly, the highest courts in California and New York have made decisions which have a similar effect of barring the enforceability of these provisions in their states. Additionally, statutes in Illinois, Maryland, Missouri, and Ohio will not enforce pay-when-paid clauses where a subcontractor’s mechanic’s lien is at stake.

### Minority Rule

In a small number of states, which have followed the approach taken by the Florida Supreme Court, subcontractors will be held strictly accountable for the language in a pay-when-paid provision. Put another way, if a pay-when-paid clause is in a contract, a subcontractor will only be paid if the general contractor has been paid by the owner. This harsh reading of the contract can lead to devastating results for subcontractors when owners do not pay. Nevertheless, a minority of states will enforce these clauses regardless of the impact on subcontractors.

### Majority Rule

A majority of the states, including Minnesota, have refused to follow the harsh reading of the Minority Rule. Instead, these states have read pay-when-paid clauses to merely provide (regardless of the language of the clause itself) a reasonable time for payment by the general contractor to the subcontractor without relieving the general contractor of its obligations to pay the subcontractors. Under this rule, the general contractor may delay payment to the subcontractor if the owner is tardy in payment. However, the general contractor will ultimately be liable to the subcontractor even if the owner does not pay.

### SIGNIFICANCE OF UNCERTAINTY

There is an important rule in reading

contracts: contracts will be construed or read against the drafter. Because most agreements between contractors and subcontractors are written by the general contractor (especially contracts containing pay-when-paid clauses), courts will interpret any unclear or ambiguous language in the contract against the general contractor and to the advantage of the subcontractor. For example, in the *Mrozik Construction v. Lovering Associates* case, a payment clause provided:

“Final payment including all retention becomes due and payable within 30 days after Architects’ certification of final payment. At all times the Subcontractor shall be paid to the extent that the Contractor has been paid on the Subcontractor’s account.”

The court found the provision to be sufficiently unclear to prevent a contractor from arguing that this was an enforceable pay-when-paid clause. In refusing to enforce the provision as a pay-when-paid clause, the court held that a contract “should not be construed to make payment to the general contractor a condition precedent to payment to the subcontractor, absent unequivocal, unambiguous language to that effect.”

While Minnesota courts have refused to enforce these provisions if an ambiguity exists, the question remains: will the court find a provision ambiguous? This creates uncertainty for both the subcontractor and contractor.

The impact of an owner failing to pay for work with no recourse against the general contractor is obvious. Subcontractors usually provide substantial value to a project through labor and materials. The general contractor often provides only job oversight. Therefore, the party taking the significant financial “hit” is the subcontractor if pay-when-paid clauses are enforced.

The implications of these pay-when-paid clauses for subcontractors providing services in multiple states are also important. Usually multi-state projects involve a large and complex construction contract (often an AIA form). Contractors should be aware that such contracts usually contain a “choice of law” clause which designates the state whose law will govern in any disputes between the parties. If the contract designates a state which does not ban pay-when-paid clauses, the subcontractor will be held accountable to the extent an owner does not pay.

### PROTECTING SUBCONTRACTORS

Subcontractors in Minnesota should consider the following:

1. Require a pay-when-paid clause to be removed from your contract;
2. Substantially increase your price to

reflect the increased risk associated with the inclusion of a pay-when-paid clause;

3. Require a personal guaranty or letter of credit from the owner; or
4. Strongly consider refusing to sign a contract if you are not provided with one of the first three items above.

Additionally, if you are a subcontractor in a project containing a pay-when-paid clause, you are now playing a significant financial role in the project and are in the position a general contractor traditionally occupies with respect to the owner. Accordingly, you should receive financial records confirming timely payment to all other subcontractors and copies of communication with the owner’s bank concerning the release of any construction loan payments. If you see evidence that the owner is failing to make timely payments, you should consult with your attorney to discuss limiting your labor or

materials on the job until you receive adequate assurance that you will be paid.

### CONCLUSION

A pay-when-paid clause shifts the obligation of collection from the general contractor to the subcontractor. Unless the subcontractor removes, modifies, or engages in other activity to limit its risk, it could find itself “holding the bag” when an owner defaults.

*If you have any questions, please contact Steve Yoch in our St. Paul office.*



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# Welcome Our New Attorneys

Felhaber, Larson, Fenlon and Vogt, P.A. is pleased to announce that **Wendy M. Brekken, Donald G. Heeman** and **Pomy Ketema** have joined our firm. Please join us in welcoming them to Felhaber.

## WENDY M. BREKKEN

Ms. Brekken practices in the areas of real estate, estate planning, and business law. Prior to joining Felhaber, she was employed as a credit analyst for an automobile finance company.

Ms. Brekken graduated with a B.A., magna cum laude, from St. Olaf College in 1997. She received her J.D. from William Mitchell College of Law in 2003.

Ms. Brekken graduated magna cum laude, in the top 10 percent of her class.



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## DONALD G. HEEMAN

Mr. Heeman's practice is devoted primarily to business and employment litigation. Before joining the Felhaber law firm, he served as an Assistant Attorney General in the Minnesota Attorney General's Office. As an Assistant Attorney General, Mr. Heeman practiced in the areas of consumer fraud, false advertising, deceptive trade practices and health licensing. Mr. Heeman has represented clients in both state and federal court, and has appeared before administrative and appellate courts.

Mr. Heeman graduated with a B.S. from Arizona State University in 1994. He received his J.D. cum laude from William Mitchell College of Law in 1998.



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## POMY KETEMA

Ms. Ketema practices in the areas of business law, general tax and estate planning, and real estate. She is a certified and licensed public accountant, and brings to the practice several years of experience in the areas of corporate transactions and restructurings, audit defense and general federal and state tax planning.

Ms. Ketema received her Bachelor of Arts degree from the University of St. Thomas in 1994, and her Master of Business Taxation degree from the Carlson School of Management (University of Minnesota) in 2001. She received her J.D. cum laude from the University of Minnesota Law School in 1999, graduating in the top 15 percent of her class. She served as a full editor of the Minnesota Law Review.



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## We're Moving!!

As of December 1, 2003,  
Felhaber, Larson, Fenlon & Vogt, P.A. is relocating and expanding its Minneapolis and St. Paul offices.

Our new addresses are effective December 1, 2003.  
The phone and fax numbers remain the same.

**Minneapolis Office**  
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**St. Paul Office**  
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**Celebrating 60 Years of Service To Our Clients**

# Marriage Vows and Title Woes

**Real estate and divorce can create some interesting legal issues affecting title, especially where the real estate is in one state and the divorce occurs in another state. The fictional case that follows illustrates why care should be taken, at the time of the divorce, to comply with the title standards of the state in which the real estate is located.**

George owned several parcels of property in Minnesota for many years. He remarried later in life. He and his new wife, Helga, lived modestly but happily for a few years, but unfortunately she then experienced some serious health problems. Helga decided to relocate to the West Coast in order to be closer to her spiritual advisor. George visited periodically, but did not desire to relocate away from Minnesota. Eventually they decided to terminate the marriage. Helga initiated divorce proceedings in her new home state. The divorce was amicable, but George found it embarrassing so he kept it to himself and did not seek advice. Instead, he simply allowed the whole matter to be handled discreetly by Helga's attorney. The divorce decree seemed to clearly reflect the parties' agreement that Helga would receive a substantial cash payment and George would retain title to all his property. Shortly thereafter, Helga's health deteriorated further and she died.

Later, George attempted to sell one of his Minnesota real estate parcels and promptly learned that the out-of-state divorce decree did not meet Minnesota standards to resolve the issue of Helga's interest in the real estate. He now faces substantial expense of legal proceedings to prove that title to the real estate is clear of claims of Helga's heirs.

Under Minnesota title standards, it is essential that a divorce decree identify property by legal description and clearly dispose of the property. In the case described above, the divorce decree was perfectly proper in the state where it was issued. Unfortunately, that state did not require

that real estate be specifically identified and, therefore, the decree did not meet the Minnesota standards. George needed advice from a Minnesota attorney before finalizing the out-of-state divorce.

Note that an equivalent problem can occur in reverse. Thus, a couple divorced in Minnesota may very well own real estate, such as a vacation home in another state. Care needs to be taken to assure that the Minnesota divorce decree will satisfy title requirements of the state where the real estate is located.

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Divorces are seldom pleasant, but it is especially painful to have to reopen the matter in order to clear title to real estate when the problem could have been avoided by taking the time to do it right the first time.

One other point to note with regard to divorce and real estate is that it is not necessary that an entire divorce decree be placed of record in the real estate records of every county where Minnesota real estate is located. There is an excellent alternative provided in Minnesota Statutes Section 518.191. That statute provides for a document

called a Summary Real Estate Disposition Judgment which essentially sets forth the legal description of the property, the fact of the marriage dissolution, and the identity of the party receiving title to the real estate. Use of that document under the statute not only saves the parties some filing fee expense, but also helps preserve some privacy.

*If you have any questions, please contact Jim Blomquist in our Minneapolis office.*



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landlord. For example, the tenant may merge with another entity and thereby radically change the nature of its business without technically "assigning" the lease. It may sell majority control of its business to another entity, triggering a change in control and possibly in the business itself. It may "spin off" its operating assets and sell the equity of the remaining entity (which holds only the lease) to a third party. It may argue that it is implementing a "joint venture" structure under which it is simply providing space under its lease for the benefit of the venture. In fact, there are multiple tenant transaction structures that could "slide below the radar", if the assignment and sublease trigger provisions are not carefully drawn.

As a general principle, in significant commercial leases, the "assignment and sublease" provisions should be drafted to encompass all "changes in control." A material corporate restructuring, substantial

sale of equity or transfer of significant operating assets should be a triggering event, allowing the landlord to make an assessment of its position. A few sentences along these lines may ultimately be more important to the landlord than pages of text defining the consequences of an assignment or sublease. It will also reduce the risk that the landlord will walk into its property one day and be faced with a "tenant" that bears no resemblance to the party that signed the lease.

*If you have any questions, you may contact Dave Cremons in our Minneapolis office.*



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*Real Estate Report* is an update on legal developments. It is not intended to be legal advice and should not be relied on without consulting counsel.

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