

## RECENT CASE LAW DEVELOPMENTS IN COMMERCIAL LEASES

September 2006

### ➤ **Rent to be taken into consideration in calculating the ceiling rent**

Upon the renewal of a commercial lease, the rent can be increased from the initial rent.

When the term of the lease is less than 9 years, pursuant to Article L. 145-34 of the Commercial Code, the rent under the renewed lease should be capped absent any significant change in any of the factors in assessing rental value (*inter alia* features of the premises, local marketability factors or prices habitually practiced in the neighbourhood).

In a general way, the ceiling rent is determined by taking into consideration the applicable rent upon the effective date of the expired lease and applying to that the variation in the INSEE cost of construction index.

This method of calculation does not present any difficulty when the applicable rent, upon the effective date of the lease coming up for renewal, is identical to that paid by the lessee during the lease.

The question arises as to what rent should be taken into consideration when the rent under a lease has been the subject of a flat contractual adjustment on a progressive basis (called "sliding-scale" leases) or of specific arrangements between the parties (reduction of rent over the first years so as to facilitate the ramp up of operations for the lessee or so as to take into consideration, for instance, refurbishing work on the premises carried out by the lessee).

The triers of the facts thus seem to be of two minds between a distributive application of the coefficient to the amount of the rent applied for each period (CA Paris, 29 April 1986) and sole reference to the initial rent (see, for example, CA Paris, 29 April 1986: D. 1986, *inf. rap.* p. 344).

The *Cour de cassation* has very clearly come out in favour of this second solution (*Cass. 3<sup>e</sup> civ.*, 17 May 2006, no. 05-11.685).

In that case, the contractual rent had been reduced by the lessor to reflect the renovation work carried out by the lessee. The lessee had argued that upon expiry of the initial lease, reference should have been made to the amount of rent actually paid upon the effective date of the lease and not the amount contractually stipulated.

By decision of 17 May 2006, the *Cour de cassation* rejected this argument, holding that in calculating the ceiling rent,

application should be made of the index variation of the contractual rent agreed by the parties upon the effective date of the lease to be renewed.

To avoid any dispute upon renewals, the parties should specify in their agreement the baseline rent in the context of the three-yearly rent review or upon renewal is that initially set and not that resulting from a decrease granted due to special circumstances.

### ➤ **Short-term lease under exemption regime: qualification and renewal**

Although commercial leases are in theory of nine years, the parties may conclude a short-term lease under the exemption regime, for a maximum duration of two years, providing for a waiver of the regime applicable to commercial leases and its mandatory public policy provisions pursuant to Article L. 145-5 (1) of the Commercial Code.

\* So as to avoid any risk of recharacterization, the parties must manifest a clear and unequivocal desire to waive the regime applicable to commercial leases. In this respect the courts have tended to refer solely to the term of the agreement so as to surmise the parties' intent to waive application of that regime.

However, Article L. 145-5 of the Commercial Code does not provide that a lease with a maximum term of two years is necessarily excluded from the regime applicable to commercial leases. It simply indicates that the parties have the possibility of escaping the regime applicable to commercial leases by concluding a lease of that term.

The strict interpretation of this provision was confirmed by the *Cour de cassation* which specified that the mere indication of a term of less than two years does not suffice to characterize the intent of the parties to conclude a lease under the exemption regime (*Cass. 3<sup>e</sup> civ.*, 2 February 2005, no. 03-19.541).

The parties should thus ensure that they word their lease agreement such that their intent to waive the application of the regime applicable to commercial leases is clear; sole indication of a term of two years or less not being sufficient.

\* It should also be recalled that Article L. 145-5 (3) of the Commercial Code prohibits the renewal of a short-term lease.

So, when the lessee remains in occupancy upon the expiry of the lease under the exemption scheme, a lease governed by the

regime applicable to commercial leases automatically becomes applicable.

This waiver is only authorized in the scenario of the conclusion of a single lease that cannot be renewed or extended, even if the total duration of subsequent leases granted does not exceed a two-year period.

On this last point, the *Cour de cassation* reiterated this principle by criticizing a court of appeal that had considered that the parties' intent had been to conclude a lease under the exemption regime for a term of less than 24 months when the lease actually provided for a term of 11 months and the lessee remained on the premises upon the expiry of that lease without any protest by the lessor (*Cass. 3<sup>e</sup> civ.*, 21 mars 2006, no. 95-10.149).

The Court of Appeal had based its rationale on a mistake by the notary drafting the agreement, who had indicated that the lease could be renewed upon the expiry of the 11-month period for a duration of 1 year, the duration of the initial lease and of the renewal term still being under two years.

The *Cour de cassation* rejected that rationale by applying a solution in that case that was consistent with its previous rulings on the consequences of the lessee remaining on the premises upon the expiry of a lease under the exemption system.

It should be recalled in this respect that when the lessee remains on the premises after lease-end the rent under the lease should be set at the rental value (*Cass. 3<sup>ème</sup> civ.*, 14 Dec. 2005 no. 05-12.587), while the other terms and conditions of the initial agreement should remain applicable unless contrary to mandatory requirements applicable to commercial leases.

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