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The Tax-Exempt Entity's Property and a Lessee's Private Purpose

By Janice G. Inman

State and local governments grant tax-exempt status to properties that are used for certain activities, including religious and charitable purposes. Properties owned by government and educational institutions are tax-exempt as well, and these exemptions can extend to lessees of such property under certain circumstances, such as when the property continues to be used for a public purpose and such use is related to the function of the lessor entity.

Questions arise, however, when a tax-exempt property's use by a lessee involves an element of private profit. Is the tax-exempt status lost? Does that answer change if only a portion of the property is used to generate income for a privately-held entity? And if an agreement between a tax-exempt entity and a private party is not termed a "lease" by them, is the private party a lessee of property or something else altogether?

The Tax Court of New Jersey was asked to answer questions like these in *Gourmet Dining, LLC v. Union Twp.*, 2018 N.J. Tax LEXIS 6 (Tax Court of New Jersey, 3/14/18), a recent case involving a restaurant space run by a for-profit vendor on the campus of a tax-exempt entity — a university. The scenario in Gourmet Dining is one likely to be repeated, in various guises, in other commercial contract situations involving tax-exempt entity-owned premises, so the court's reasoning may be instructive to those contemplating such business relationships.

The Contract

New Jersey Statutes Annotated (N.J.S.A.) section 54:4-1 provides that all real and personal property within the State of New Jersey is subject to annual taxation unless specifically exempted by the New Jersey legislature. If the legislature chooses to exempt a property from taxation, it may do so only by enacting general laws (N.J. Const. Art. VIII, section 1, para 2), and such exemptions from taxation may only be based on the use to which the property is put, not on the identity of the taxpayer. *See*, *Township of Holmdel v. New Jersey Highway Auth.*, 190 N.J. 74 (2007).

The real property at issue in *Gourmet Dining* comprised approximately 6½% of Kean University's 110,000-square-foot New Jersey Center for Science, Technology, and Mathematics building (NJCSTM Building). The NJCSTM Building was built with funds

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Considering Lease Assignment Provisions in the Light of an Enterprise's Broader Business Plan

By Terrence M. Dunn

When entering into or acquiring leases for locations, a retail or restaurant business must consider broader business concerns in negotiating the leases' assignment provisions. Those provisions can inadvertently create major obstacles in the ultimate conveyance or financing of the business.

Scenario: Consider a typical situation: a New York City-based company (the Company) operates 20 retail operations in the metropolitan area. They do not own any of the underlying real estate — each of their locations is subject to a lease. The principals are now looking to take a substantial amount of money off the table and are considering a variety of means to do so, including the outright sale of the Company or its assets, sale of a majority interest or a refinancing of the Company's operations. In the course of discussions with investment bankers and institutional lenders, they have become aware of two primary areas of concern, with peripheral issues attendant to each: 1) the sale or financing

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derived from the sale of tax-exempt bonds procured through the New Jersey Educational Facilities Authority (NJEFA), a governmental instrumentality authorized to arrange for the financing of construction projects for New Jersey educational institutions. The NJEFA owns the NJCSTM Building and leases it to Kean University, which uses it for the purpose of education. The university's Board of Trustees manages the building's operations.

The Board of Trustees resolved in June 2010 to task the Kean University Foundation with completing a restaurant project for the NJCSTM Building and finding a restaurateur to operate it. The Board of Trustees' resolution further stated that "a minimum of 10[%] of the restaurant's gross revenues annually [shall] be allocated for scholarship purposes within the [Kean University] Foundation." The Kean University Foundation was granted the exclusive right to operate, manage and control the restaurant area NJCSTM Building, but it was permitted to "subcontract its Management Right to a manager with extensive experience and expertise in the management and operation of various restaurant and catering businesses, with [Kean] University's written consent."

The Kean University Foundation entered into just such a subcontract with Gourmet Dining on Oct. 19, 2011. This Management Subcontract Agreement (MSA) called for Gourmet Dining to use its "extensive experience and expertise in the management and operation of various restaurant businesses" to "manage and control" the restaurant facility. Under the terms of the MSA, Gourmet Dining was to be responsible for "all expenses relating to the Facility during the Term, including but not limited to food costs and inventory expenses, liquor costs, supplies, salaries, Manager's salaries (if any), payroll expenses, taxes of every kind and nature (corporate taxes, sales taxes, federal, state and local taxes), equipment leases, advertising, licenses, and fees, insurance, maintenance and improvements, normal janitorial services and phone bills." Gourmet Dining would reap the profits of the operation but would pay the Kean University Foundation "management fee[s]" of $250,000 per year for the first nine years and $500,000 in the 10th year, as well as 12.5% of the gross revenues (payable quarterly). Throughout the MSA, language like this indicated that Gourmet Dining was meant to manage the restaurant facility, not lease a piece of real estate in which to run its own restaurant. The restaurant that Gourmet Dining opened was called Ursino.

The Taxing Authority Sees A Private Business

With this background in mind, we move to Aug. 27, 2012, when Union Township sent Gourmet Dining a letter explaining that it would soon be receiving a tax bill "for the Ursino Restaurant facility at Kean University." The township relied upon N.J.S.A. 54:4-2.3 to conclude that Gourmet Dining was a "lessee" of the restaurant portion of the NJCSTM Building; as such, the township's letter explained, it was "required to assess as taxable real property the portion of Kean University's Stem Building used and operated by Gourmet Dining, LLC as the Ursino Restaurant." Taxes for the Ursino property were assessed at $50,000 a year for the land and $250,800 for improvements upon it.

Gourmet Dining complained to the court that because it was not a leaseholder of the restaurant space but merely the restaurant's manager, the property that Kean University had leased from the NJEFA must be treated as Kean University's. Kean University was joined as a party and agreed with Gourmet Dining — both of them arguing, among other things, that the MSA was not subject to local property taxation because it was not a lease.

Union Township moved for summary judgment, asserting that

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Gourmet Dining's interest in the property under the MSA was fundamentally a leasehold subject to local property tax under N.J.S.A. 54:4-2.3. Gourmet Dining continued to maintain that the MSA was not a lease, and also that it was entitled to tax immunity because it was actually using the premises in a manner that advanced the cause of education and that the restaurant operation was serving the public purposes of Kean University.

Was It a Lease?

In New Jersey, when a property is tax-exempt because it is, for example, part of a school or church, that tax-exempt status is not absolute if the property is leased out. In those cases, the leasehold taxing act, N.J.S.A. 54:4-2-3, is consulted to see whether the property remains non-taxable. It states:

> When real estate exempt from taxation is leased to another whose property is not exempt, and the leasing of which does not make the real estate taxable, the leasehold estate and the appurtenances shall be listed as the property of the lessee thereof, or his assignee, and assessed as real estate.

(Before addressing the core issues, the court pointed out that even though Kean University and its affiliates are tax-exempt entities, if they leased out a portion of their premises to a party whose operations were not tax-exempt under the law, that portion of the real property used by the lessee would not become taxable — instead, the *leasehold interest* would become taxable.)

So, a preliminary question was, were the rights Gourmet Dining obtained under the contract a leasehold or something else?

A lease is a contract for exclusive possession of lands or other things for a prescribed term (a certain number of years, for life, at will, etc.), normally in exchange for rent or some other compensation. *Black's Law Dictionary*, 889 (6th ed. 1990). The lessor may retain some rights, but they must not be inconsistent with the rights granted to the lessee. If the agreement allows the lessor to cancel the agreement at will, it is a license and not a lease. However, whether the parties call the agreement a "license" or "lease" is not determinative; instead, the nature of the agreement controls. New Jersey's Supreme Court has stated in this regard:

> [W]hether a particular agreement is a lease depends upon the intention of the parties as revealed by the language employed in establishing their relationship, and, where doubt exists, by the circumstances surrounding its making as well as by their course of operation under it …. And, in situations where the ambiguity or doubt gives rise to a factual question as to the intention of the parties, the burden is on the party asserting it to demonstrate existence of the lessor-lessee relationship. Moreover, in the resolution of ambiguity or doubt, absence of (1) a stipulation for rent as such, or other consideration regarded by the parties as constituting payment for the transfer of possession, and (2) a term; and presence of (1) limitations on exclusive possession and control of the premises, and (2) a right in the owner to revoke the permit to use at any time, are factors militating against the existence of a lease.

Thiokol Chemical Corp. v. Morris County Bd. of Taxation, 41 N.J. 405 (1964) (internal citations omitted).

Gourmet Dining and Kean University argued that the contract was not a lease, and was thus exempt from taxation under section 54:4-2-3, for a number of reasons. First, the contract did not contain the term "lease." In addition, according to Gourmet Dining, it had not acquired the exclusive right to occupy the property, did not obtain the right to use the name "Ursino," and had a duty under the contract to operate the restaurant to the satisfaction of the Kean Foundation.

To analyze the situation, the court consulted *Van Horn v. Harmony Sand & Gravel, Inc.*, 442 N.J. Super. 333 (App. Div. 2015), for its guidance that the use of the term "lease" is not determinative of whether a contract is a lease or not. It may be a lease or it may be a "license," which the *Van Horn* court described as "an agreement that only gives permission to use the land at the owner's discretion." But if the agreement was a lease and not a license, then, in accordance with section 54:4-2-3, the leasehold interest could lose the tax-exempt status enjoyed by the lessor. To come to a conclusion on this point, the court sought the answers to two questions: 1) Did the MSA have the requisite features of a lease and, if so; 2) did the contract give Gourmet Dining the rights associated with a lease?

To have all the earmarks of a lease, the agreement between the Kean Foundation and Gourmet Dining would have to: 1) be a contract; 2) for a defined property; 3) to be in effect for a defined period; and 4) require the party taking possession of the premises to pay a fixed amount. All of these factors applied to the MSA contract, as Gourmet Dining had the right to operate, manage and control the facility, for 10 years, and for an agreed-upon payment to be made to the Kean Foundation.

Having determined that the basic elements of a lease existed under the MSA, the next question was whether the MSA afforded Gourmet Dining rights akin to those of a lessee. For help on this, the court turned again to the New Jersey Supreme Court's *Thiokol Chemical* case. There, the United States had contracted with a private company, allowing it to use U.S. land and the improvements upon it to do work for the United States. The *Thiokol* court determined that the agreement between the United States and the company was not a lease because the United States retained the right to inspect the company's work, controlled the work by keeping a staff of 10 U.S. employees on the property for that purpose, and had the right to terminate the private company's services

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on written notice at any time. These things meant that the private company lacked the rights of a lessee — it had only limited control over the property in question, and its rights were immediately extinguishable by the United States, even absent cause. Such was not the case with the Kean Foundation/Gourmet Dining agreement, which afforded Gourmet Dining concrete rights that lessees enjoy.

Further, the court noted that while the MSA required Gourmet Dining to operate only a restaurant and no other business, did not permit it to control the name of the business, and compelled it to meet certain standards set by the University's representatives — all tending to indicate a license rather than a lease — many leases require a lessee to run a specific type of business, and only that one type, and require lessees to meet specific minimum standards, such as preserving the property in good condition and refraining from interfering with other lessees on the premises. So these things were not dispositive. On the contrary: "Under the MSA," the court stated, "Gourmet Dining retains a possessory right in the subject property and control over Ursino's operations, employees, liquor license, income and expenses. The MSA does not financially restrain Gourmet Dining in any manner. The MSA grants Gourmet Dining 'the exclusive right to operate, manage and control the Facility …' and names Gourmet Dining as 'exclusive manager of the Facility,' responsible for 'all reasonable, necessary and advisable management and operational services … and in compliance with all applicable municipal, county, state and federal laws, statutes, ordinances, rules and regulations.'" The court found it even more significant that the MSA gave the Kean Foundation no right to unilaterally terminate the agreement without cause. Rather, the court observed: "Under the MSA, Gourmet Dining enjoys the right to freely operate Ursino on its own terms, and hence can be said to enjoy the exclusive use, enjoyment, and possession of the subject property."

All these things led the court to conclude that, for the purposes of deciding the motion for summary judgment, Union Township had established that the MSA was "functionally a lease," despite the Kean Foundation's continuing rights to do certain things that most leases may not allow. Stated the court: "The MSA may not be an optimal agreement from Gourmet Dining's perspective, but a lease with less-than-ideal terms does not cease to be a lease."

Therefore, the Gourmet Dining leasehold interest was amenable to being taxed, unless it could be shown, in accordance with other statutes, that Gourmet Dining's Ursino restaurant was entitled to immunity from taxes because it stood in the shoes of Kean University by serving the public interest Kean University was entrusted with serving.

Actual Use

New Jersey Statutes Annotated 54:4-3.6 explains that premises used by educational entities are to be tax-exempt, so long as they are actually being used for educational purposes. The statute states, in pertinent part:

> The following property shall be exempt from taxation under this chapter … all buildings actually used for colleges, schools, academies, or seminaries, provided that if any portion of such buildings are leased to profit-making organizations or otherwise used for purposes which are not themselves exempt from taxation, said portion shall be subject to taxation and the remaining portion only shall be exempt.

Gourmet Dining and Kean claimed that the Ursino property was actually being used for college purposes. Their primary argument here was that because Kean was paid the management fee and a percentage of gross revenues, the restaurant's profit (or at least some of it) was going back to Kean University's "cause of education."

The court was unconvinced, however, because although some profits went to Kean, most of the profits were still going to Gourmet Dining. As explained in *City of Trenton v. State, Div. of Tax Appeals*, 65 N.J. Super. 1 (App. Div. 1960), the question to be asked in situations like this is, "Who gets the money?" The City of Trenton court said that if money is generated from profit-making operations on a normally tax-exempt property, courts should look to see if it can be traced to "someone's personal pocket" and to whether that profit is the primary reason for the operation. If so, then the entity profiting from the use of that otherwise tax-exempt property is not entitled to tax immunity.

Here, the court concluded that "all profit belongs to Gourmet Dining." Thus, Gourmet Dining was not entitled to exemption from tax based on an actual use of the property for educational purposes.

Serving the 'Public Purpose' Of Kean University

New Jersey Statutes Annotated 54:4-3.3 states, in pertinent part to the public purpose/tax exemption issue: "[T]he property of the State of New Jersey; and the property of the respective counties and municipalities, and their agencies and authorities, school districts, and other taxing districts used for public purposes … shall be exempt from taxation under this chapter."

The court found because Kean University was established as a part of the New Jersey Association of State Colleges and Universities in accordance with N.J.S.A. 18A:64-45, Kean University was a public entity, and the NJCSTM Building was a governmental property, such that N.J.S.A. 54:4-3.3 applied to them. "Additionally," stated the court, "it is undisputed that Gourmet Dining is a for-profit corporation, and its operation and management of Ursino are conducted for-profit." Therefore, the court was required to determine, in accordance with *Township of Holmdel v. New Jersey Highway Auth.*, 190 N.J. 74, 918 A.2d 603

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of the Company may require or be defined as the assignment of the underlying leases, requiring compliance with each lease's assignment provisions; and 2) an institutional lender may require a leasehold mortgage on the leases for each of their locations.

When they consult their attorneys to discuss these particular aspects of the transactions under consideration, they find that the leases were negotiated at different times with different landlords and, in some cases, by different lawyers. Each document started with the landlord's form of lease. As a result, there is no uniformity in the clauses in question. Each lease addresses assignment in a different manner. Accordingly, the real estate aspect of their desired transaction, no matter what form it takes, will require a good deal of work and negotiation. In fact, the response and possible objection of certain landlords to the proposed larger business transaction may add additional cost to the transaction, or even prevent it from happening, for reasons that will be explained below.

Working backwards, this could have been avoided by a coherent lease negotiation strategy that specifically analyzed the assignment provisions with an eye toward the bigger picture.

What Could Have Been Done

Reviewing the leases, there are a number of different clauses in each lease that become relevant to an analysis of how a broader transaction can be effectuated. Please note that the described scenario is essentially real, changed somewhat to preserve anonymity, but every reference in this article to a lease provision comes from actual lease agreement clauses.

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General Assignment Provisions

Assignment provisions in commercial leases generally present one or more variations of how an assignment is defined, permitted, or not permitted (we are going to omit discussions of sublet rights, as they are a lesser concern and do not affect the broader business transactions under consideration here). The leases for the Company described above contain most of the usual variations:

- Assignments not permitted without landlord's consent, with no conditions attached;
- Assignments permitted only with landlord's consent, not to be unreasonably withheld, with reasonability only generally defined or, more commonly, not defined at all;
- Consent not to be unreasonably withheld, with criteria established as to what constitutes a reasonable refusal to consent, or, conversely, criteria that would require consent if standards or parameters are met; and/or
- Assignment not permitted without consent, with certain exceptions which do not require consent or for which consent is presumed granted (sometimes referred to as Permitted Transfers):
  - To an entity resulting from the merger, consolidation or reorganization of tenant or to the entity benefiting from the sale of substantially all of the tenant's assets;
  - To an entity of net worth (or some other measured financial standard) equal to or greater than the tenant, or meeting some specific numerical standard (*e.g.*, $1.5 million net worth and $750,000 liquidity); and/or
  - To an entity that operates a specific number of units similar to tenant's business, having five years' operating experience and a net worth equal to or greater than tenant's.

The Requirement of Consent

Every lease considered in the transaction under discussion contained specific assignment provisions. However, we have seen leases in other contexts that are silent on the concept. For those, it has been held that "where the lease did not make any reference to assignability other than providing that the lease would bind the heirs and assigns of the parties, the court refused to recognize the existence of an implied limitation upon assignment and stated that such a covenant is to be recognized only if it is clear that a reasonable landlord would not have entered into the lease without such an understanding." *Rowe v. Great Atl. & Pac. Tea Co.*, 46 N.Y.2d 62, 69-70 (1978). Quoting *Mutual Life Ins. Co. of N. Y. v Tailored Woman*, 309 NY 248, 253, the *Rowe* court said: "Courts should be extremely reluctant to interpret an agreement as impliedly stating something which the parties have neglected to specifically include. As we have previously declared in a similar context, 'such lack of foresight does not create rights or obligations.'" Accordingly, if the lease does not require consent to an assignment, it should not be inferred.

The Definition of 'Reasonability'

The issue of reasonability in consent is fundamental. "[W]hen a commercial lease provides that the landlord will not unreasonably withhold consent to its assignment, the landlord may refuse to consent to an assignment based only on 'consideration of objective factors, such as the financial responsibility of the [proposed assignee], the [proposed assignee's] suitability for the particular building, the legality of the proposed use and the nature of the occupancy, *i.e.*, office, factory, retail.'" *Logan & Logan, Inc. v. Audrey Lane Laufer, LLC*, 34 A.D.3d 539, 539-40 (2006) (quoting *Astoria Bedding, Mr. Sleeper Bedding Ctr. v Northside Partnership*, 239 AD2d 775, 776 (1997)). So, reasonability in application needs to be tied to specific factors.

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Definitions of 'Assignment'

There are other issues affecting the standards imposed upon the actual request for an assignment. Some transactions will be deemed to be assignments, if not expressly structured that way. A business enterprise may engage in a stock sale, as opposed to an asset sale. An asset sale would involve the actual assignment of each lease to a new acquiring entity. A stock sale would involve the sale of the equitable ownership in the operating entity and/or its affiliates. This would not require an actual assignment of the lease, since the tenant entity is not changing, but many, if not most of the leases involved in this transaction contain "Change of Control" provisions that deem a change in the ownership or control of the tenant entity to effectively be an assignment, requiring that the assignment requirements outlined above be adhered to. The leases must be examined for this definition.

Recapture or Termination Rights

Some of the leases in this transaction contain the right on the part of the landlord to require notice of any assignment and afford the landlord with the corresponding right to either take the lease back from the tenant or to terminate the lease. Obviously, in the context of the sale of a group of businesses as a block, this could not be permitted to happen. These landlords will have to be approached carefully to avoid triggering this right, and that avoidance may prove expensive.

Encumbrances and Leasehold Mortgages

Some of the leases define any form of encumbrance as an assignment. In the refinancing scenario, a bank's leasehold mortgage would require compliance with the assignment provisions. Other leases have specific and separate leasehold mortgage provisions, which are similar to assignment provisions in that they require adherence to requirements concerning the rights of the lender, the superiority of the rights of the landlord, and the manner in which these instruments can be entered into. While a bank may be willing to lend with a leasehold mortgage as collateral, the leases must be examined to see if the landlord has agreed to give to a lender such rights as they will require.

Releases

Many leases specifically do not release the original tenant nor the guarantors of the tenant in the event of an assignment. Some leases will permit such releases in the event the assignee provides a guarantor of equal or greater financial ability or the assignee possesses sufficient financial ability to replace that position. Completing the sale of a multi-unit business system with the seller remaining liable for certain obligations can complicate the transaction, requiring indemnifications and protections for the seller in the transaction.

Changes in Terms

One of the leases in this transaction permits the landlord, upon an assignment, to impose "commercially reasonable" changes in the terms of the lease, taking into account changes in the overall real estate market. This can result in a rent increase to the assignee, which will inevitably alter the terms of a larger transaction of which this location forms a part.

Landlord's Share Of Consideration

Many leases contain provisions that permit the landlord to claim a share of any consideration received by the tenant as a result of the assignment, sometimes as much as 50%. This is intended to prevent tenants from making money on an assignment of an attractive location by charging "key money" or other transfer fees — the theory being that only the landlord should be able to make a profit from its real estate. The problem is that an assignment in connection with the sale of business will inevitably have other consideration involved. The landlord should not be able to make a claim against that. Some of the leases, but not all, specifically exclude compensation attributable to the sale of the tenant's business.

Conclusion

So now let us view the proposed transaction from two perspectives.

First: The client comes to you and says they are interested in the sale or financing of their existing system of 20 units and retain you to handle the real estate part of this transaction. Assuming the transaction turns out to be an outright sale of the business in the form of an asset sale, you must then engage in 20 discrete transactions with each of the seller's landlords, evaluating the terms of the leases and determining what the best position is to take with respect to the transaction in question. The proper action in the context of any given lease will not always be clear. For instance, the lease may permit an assignment without consent to an assignee of "suitable net worth," but it then becomes necessary to decide how net worth is to be measured and what "suitable" means. It may be necessary to negotiate with the landlord to reach an agreement that the assignee is acceptable, in order to avoid the risk that the landlord will serve as an impediment to a closing of the larger transaction. Each lease must be dealt with in a manner where the representations and indemnifications that are typical to a transaction of this nature can be fully supported by the actions taken with respect to each landlord. There can be no risk to the seller or buyer of any landlord raising an issue post-closing.

Second: A client with a business model comes to you with the request to negotiate a lease for her first retail location in New York City. When the time comes to review the proposed lease, you analyze the assignment provision and find it unclear in terms of practical application, as well as being too restrictive. Your client is eager to get the business open and tells you that she has no plans to assign the lease, so don't make a big deal about it. You advise her that this may be the first of many leases and that each one should take a uniform approach, referencing clear and achievable

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criteria of what constitutes an acceptable assignment, so that when the day comes that there are twenty of these locations and she wants to sell them all, that can be accomplished smoothly with all of her landlords.

While the second scenario is admirable and correct, most clients do not have the patience to insist on specific and potentially objectionable language in what they consider to be an arcane section of the lease. To avoid the first scenario, you must have broad business vision and convince not only the landlord, but also your client, that these provisions are necessary.

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(2007), whether Gourmet Dining's "use, possession, and occupancy of the subject property as a restaurant fulfills a statutory purpose afforded to Kean."

First, the court observed that New Jersey's Supreme Court held the case of *Borough of Moonachie v. Port of New York Authority*, 38 N.J. 414 (1962), that "property employed primarily for a public use does not lose immunity [from taxation] because [an] agency *incidentally derives* some private business income from it." And just as a government entity can gain incidental income while serving its public purpose without losing its tax-exempt status, a lessee of the agency might also enjoy tax immunity under circumstances akin to those that would exempt the agency itself, so long as the lessee is operating the property in accordance with the agency's statutory purpose. *See*, *Township of Holmdel*, *supra*. However, *Borough of Moonachie* also explains that "a tax exemption based upon a statute specifying a particular public use is clearly lost when the use to which the property is put is foreign to the prescribed use and the revenue motive in adopting the use is the primary or exclusive one." Therefore, if Gourmet Dining and Kean wanted to show the restaurant's operators were entitled to tax exemption under N.J.S.A. 54:4-3.3, they would have to show that Gourmet Dining was carrying on the public purpose of Kean University.

Gourmet Dining and Kean argued that the restaurant operator was promoting the public purpose of Kean University because: 1) the restaurant is a public dining establishment that may be used by Kean students and the Kean community; 2) a portion of Ursino's gross revenues are paid to the Kean Foundation, which in turn, provides scholarships to Kean students; 3) Ursino raises the public profile of Kean University; 4) the restaurant provides employment opportunities for Kean University students; and 5) Ursino is integrated into Kean's mission of environmental stewardship. On all of these arguments the court was unimpressed.

The fact that the university's students, instructors and administrators were entitled to eat in the restaurant, along with the rest of the public, did not show that the restaurant was an extension of Kean University's provision of a public good, the court concluded. Granted, the provision of dining facilities for the use of students and other university-affiliated persons is specifically designated by the State's legislature as a legitimate activity furthering the mission of public institutions of higher learning under N.J.S.A. 18A:72A-18. However, Ursino did not fit into the definition of a university dining facility. Ursino did not, for example, allow students, faculty or administrators to eat there on any university food plan. The university also did not designate Ursino as one of the university's student dining options in its literature, though it cited to six other such establishments, and Ursino offered no discount to students or faculty. Therefore, the court concluded that Gourmet Dining, by allowing students to eat in Ursino at market rates, could not claim to be providing any public service Kean University was charged with providing.

The provision of scholarship money did not move the court either, as it saw no good reason that a "for-profit entity should be entitled to a local property tax exemption simply because part of its gross revenue stream is remitted to a public entity and then allegedly allocated to further the public entity's purpose."

Gourmet Dining and Kean then argued that Ursino was being "used for public purpose" because it "fulfills the University's plan to have a restaurant that raises the public profile of the University." The court didn't really bother to explain why this point did not sway it in Gourmet Dining's direction, possibly because it considered any rise in the university's public profile attributable to the restaurant's existence to be minimal, or perhaps because the raising of the university's public profile was simply not a "public purpose" germane to the question of tax-exemption.

As to student employment at Ursino, the court noted that any such jobs were merely incidental — some employees were students, others were not, and none of the students were working at the restaurant because of work-study programs or the university's provision of financial aid to them. This was not enough to warrant an extension of the university's public-purpose-based tax exemption to the restaurant's operators. "If this court were to conclude, as Gourmet Dining suggests, that the employment of college students serves a public purpose," the court opined, "then any for-profit business operated on, or in close proximity to, a college or university employing students would be entitled to seek a local property tax exemption. Affirmation of such proposition would eviscerate the current system of local property tax assessment and exemptions."

Ursino's participation in Kean University's environmental stewardship initiative was also inadequate to convey tax-exemption to the restaurant. The court found that although

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CASE NOTES

She's Not a Third-Party Beneficiary

A Federal District Court has dismissed contract-related claims brought by an injured third party who alleged her injuries were caused by a landlord's failure to ensure that that its tenant complied with the terms of landlord and tenant's commercial lease. *Rush v. 220 Ingraham Operating Corp.*, 2018 U.S. Dist. LEXIS 84575 (E.D. Pa. 5/18/18).

Olivia Rush allegedly suffered a traumatic brain injury after tripping on flooring at a dance studio. Her mother sued the dance studio's landlord, Ingraham Operating Corp. (IOC), for breach of contract for failing to enforce the lease terms: 1) requiring the tenant to have the City of Bethlehem, PA, inspect the premises and approve its use as a dance studio; and 2) requiring the tenant to obtain $1 million in liability insurance. The tenant did neither of these things, and the lack of insurance left the tenant largely judgment-proof.

The plaintiff claimed that Olivia was an intended third-party beneficiary of the lease because the tenant and landlord owed a duty to her as a business invitee and because she was a member of a class of persons that the City inspection was designed to protect. The court observed that, under *M.S. v. Cedar Bridge Military Acad.*, 904 F. Supp. 2D 399 (M.D. Pa. 2012), a person can be deemed an intended third-party beneficiary of a contract if she is specifically named in the contract as such (which was not the case here), or if the following two-prong test is met: 1) circumstances compel recognition of the beneficiary's rights in order to give effect to the parties' intentions; and 2) either the performance satisfies an obligation of the promisee to pay money to the beneficiary or the circumstances indicate that the promisee intends to give the beneficiary the benefit of the promised performance. Neither of these conditions was met in this case because city inspection requirements in leases have been held by Pennsylvania courts not to confer benefits on the public (*see*, *e.g.*, *Hicks v. Metro. Edison Co.*, 665 A.2d 529 (Pa. Commw. Ct. 1995)), and Pennsylvania courts have also held that insurance clauses do not create third-party beneficiary status because they are typically drafted to protect lessors, not the lessees' business invitees (*see*, *e.g.*, *Bryan v. Acorn Hotel*, 931 F. Supp. 394 (E.D. Pa. 1996). The plaintiff's contract claims were therefore dismissed.

Tax-Exempt

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the restaurant bought much of its produce from a farm operated by Kean University and returned to the farm compostable refuse, Gourmet Dining "proffered no evidence to show that the produce purchases from, and compost contributions to, Kean are not simply arms-length business transactions entered into for the convenience of Gourmet Dining, or as cost saving mechanisms for Gourmet Dining with regard to the positive image fostered by such transactions." Besides this, nothing in the lease contract itself *required* Gourmet Dining to buy from the university's farm or to give back to it compostable materials.

Conclusion

The agreement between the Kean Foundation and Gourmet Dining may not have looked like a traditional property lease, but several things overrode the "management contract" language to convince the court that it was nevertheless a lease; particularly important were the amount of freedom the restaurant company retained to run the operation as it saw fit, and the guarantee that, absent breach, Gourmet Dining would remain in possession of the restaurant premises for the agreed-upon fixed term. The "actual use" argument also fell flat, and although New Jersey's case law shows the state interprets broadly the term "public purpose," when it came to extension of the university's tax-exempt status to this lessee, the definition could not be stretched quite far enough to help Gourmet Dining.

The lessons to be taken from *Gourmet Dining* are that fashioning a contract in a way to make it appear that it is not a lease but something more like an employment contract are likely to fail when the classic *indicia* of a lease — like transfer of the right to possession of a premises, payment for same, and a guarantee of the transferee's continued possession for a set term — are present. And vague or minor contributions to a tax-exempt entity's mission will not counter the fact that a private lessee's purpose for using the leased property is its own profit.

Ultimately, when the arrangement is anything like Gourmet Dining's and Kean University's, any private party contracting to use what was previously a tax-exempt property for a profit-making operation should figure tax costs into its business decisions.

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