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Workshop 19

Subleasing: You Were in it for the Long Haul but Now Need to Pivot [Advanced]

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A. INTRODUCTION

There are many reasons a tenant and subtenant may want to sublease their premises – the primary reason being flexibility. When a tenant enters into a lease agreement, it has a solid and hopefully permanent plan for its business and the lease is a big part of that plan. However, as we all know, plans often change and with a little foresight the ability to sublease all or a part of its space can allow a tenant to modify its plans with little to no disruption to its business. A subtenant also benefits from subleasing a space by allowing a subtenant to temporarily utilize an improved premises, often in a market that may not otherwise be available.

It is important to note that although subleasing can offer a tenant flexibility, a sublease can only transfer some of a tenant's rights – not all - and the tenant will continue to remain obligated under the master lease during the entire sublease term. Therefore, it is critical to know exactly what potential issues can arise when negotiating subleases.

But how to do you start a sublease negotiation and what types of issues should you consider? Did the tenant negotiate the appropriate considerations in the original lease agreement – for example, limiting master landlord's consent rights, limiting the time period for notice to a master landlord, or capping fees charged by the landlord for considering a proposed sublease, just to name a few. Coming into a sublease negotiation prepared to answer these questions will help facilitate a smooth sublease negotiation.

B. COMMON PRELIMINARY ISSUES

Before diving into sublease negotiations there are a number of preliminary issues that can arise between this new three-party dynamic that each party should consider.

a. **CONSENT**: A common preliminary issue is whether or not a tenant is required to obtain consent from the master landlord. This is often a preliminary issue because it requires lead time and can potentially tack on months to a sublease negotiation if not timely obtained.

A lease agreement will describe in its assignment and subletting provision what type of consent is required by the master landlord, if any. The type of consent requirements typically fall within three categories (a) not requiring consent in any sublease scenario, (b) requiring consent only if the potential subtenant is an unaffiliated third party of the tenant, or (c) requiring consent whether or not the subtenant is an affiliate of the tenant or an unaffiliated third party.

If the master lease agreement requires consent from the master landlord it may also require a net worth or liquidity requirement of the subtenant. From a master landlord's perspective, this makes sense. They want to confirm whether the subtenant will be able to perform under the lease and this requirement provides them that assurance. From a tenant's perspective, this can limit to whom the tenant can sublease its premises. Often times the language in a master lease describing the net worth and liquidity requirements require the amounts to be the same net worth or liquidity amounts the tenant held at the master lease commencement date. From a subtenant's perspective, these requirements can seem onerous. If a subtenant is only subleasing a portion of the premises, providing financing information to master landlord may seem unnecessary and an administrative burden when the tenant will still be "on the hook" for any delinquent rental or other payments required under the master lease.

b. **WHAT FORM SHOULD YOU USE**? In general, there are two types of "form" sublease agreements. The first is considered a "short form" sublease, and used when the entire leased premises is subleased. These forms only negotiate a few key lease provisions while the majority of the substantive lease provisions simply defer back to the master lease. Alternatively, the second type of form is often more tailored and can be as lengthy as a master lease agreement. These forms are used when only a portion of the leased premises is subleased and there needs to be a distinct allocation of items such as rent, additional rent, maintenance, etc. Regardless of the form used, a subtenant will be subject to the terms of the master lease as well as the terms of the sublease agreement and both should be reviewed in detail to confirm that there is no ambiguity amongst the parties and their obligations.

c. **ARE YOU TRULY STANDING IN THE SHOES OF THE TENANT**? Is a subtenant truly standing in the **shoes** of a tenant under a sublease agreement? In most cases they are not. Under a sublease, a tenant cannot shift any of its legal risks because a tenant will continue to maintain privity of contract with a master landlord and thus, remain obligated to perform under the sublease agreement. In kind, if a master lease terminates,

a sublease also terminates. Consequently, for a subtenant it is important to assess the risk and exposure and identify any potential problems under the master lease prior to entering into a sublease.

C. HOT TOPICS: TERMS AND PROVISIONS MOST OFTEN NEGOTIATED IN A SUBLEASE AGREEMENT

It may seem that subleasing a space from another tenant is an easy and straightforward option and would be a more advantageous business decision in terms of rent price, shorter term length, and speed of negotiation of the written agreement for the contemplated space; however, a commercial sublease often times triggers issues and challenges that don't always come up in a lease agreement directly between a tenant and landlord. Accordingly, any party considering entering into a sublease agreement should consider the risks and perform sufficient due diligence before entering into a sublease agreement.

Fundamental to the concept of subleasing is the idea that any right that a subtenant would have to the subleased premises is based on the rights that the tenant (i.e., sublandlord) has to the premises as set forth in the master lease with the master landlord. Therefore, any party contemplating to sublease a commercial space should take the time to carefully review the terms of the master lease to understand what it would be signing up for. Often times, a sublease agreement will expressly state that the sublease agreement is subject to all the terms and conditions as set forth in the master lease, except as otherwise set forth in the sublease agreement. However, in the absence of this explicit language, the parties involved should understand that this concept is the fundamental foundation of any sublease agreement. We'll now discuss the terms and provisions most often negotiated in a sublease agreement.

a. **PERSONAL RIGHTS**: Can a subtenant be granted rights that are personal to the tenant/sublandlord under the master lease? Some examples include renewal options, rights of first offer, and rights of first refusal.

Generally speaking, if the master lease includes rights that are personal to the tenant such rights personal to the sublandlord would not typically transfer to the subtenant – unless the master landlord expressly grants the subtenant that right – either in the sublease agreement, or alternatively, the master lease included a pre-negotiated term allowing for such transfer of the personal rights. Consequently, it is essential that a subtenant review and understand the terms of the master lease to determine which rights of the tenant would or would not transfer to the subtenant.

Depending on the specific circumstances surrounding the contemplated sublease, the subtenant, the sublandlord, and the master landlord may or may not want certain rights to automatically transfer to the subtenant. For instance, if the leased premises is located in a popular and a highly sought after area or located in an active and booming rental market, then the master landlord may prefer that any renewal option or rights of first offer or right to transfer not transfer to the subtenant because the master landlord wants the flexibility to lease out the space to an entirely new tenant based on higher rents immediately following the sublease's expiration. Alternatively, if the leased premises is located in a rental market that is historically less active or sleepy neighborhood with more vacancies, the master landlord may be more inclined to allow the transfer of rights to enable a longer subtenancy.

Whether or not rights that are personal to the tenant transfer to the subtenant should be considered on a circumstantial basis. Generally speaking, if the master lease includes rights that are personal to the tenant, such rights usually do not transfer to the subtenant unless such transfer of rights is explicitly agreed to by the master landlord.

b. **PERMITTED USE**: Is the permitted use set forth in the master lease applicable to subtenant's use?

The subtenant's intended use for the leased premises is important to consider. Retail leases are arguably the most challenging to sublease as compared to residential or office leases where the permitted use is less of an issue because the master landlord often times cares very much about the tenant mix and exclusive use restrictions.

The sublandlord and subtenant's ability to (re)negotiate the permitted use clause is generally very limited. More often than not, the master landlord has more leverage relative to this term because the permitted use clause and transfer of interest provision of the master lease would have already been heavily negotiated between it and the tenant.

c. **MAINTENANCE AND REPAIR OBLIGATIONS**: Which party is responsible for maintaining and repairing the leased premises?

Different considerations are required depending on whether the building in which the leased premises is a multi-tenant or single tenant building and whether the subleased premises is a portion or all of the premises leased under the master lease.

In a single-tenant building, the master lease usually requires that the tenant maintain and repair all non-structural portions of the building, including HVAC, electrical, and plumbing systems exclusively serving the building. These obligations of the tenant would usually transfer to the subtenant, if the subtenant is taking over the entire portion of the leased premises.

In a multi-tenant building, the master lease usually allocates maintenance and repair obligations to the tenant to the extent that the maintenance or repairs would exclusively benefit the tenant or the other building tenants (i.e., common area space or systems). Under this scenario, the obligations of the tenant typically transfer to the subtenant relative to the subleased premises. However, the obligations of the master landlord should not transfer to the sublandlord as the sublandlord should avoid taking on more responsibility than as is required in the master lease. Accordingly, the sublandlord would be best served by agreeing to use reasonably commercial efforts to notify the master landlord of the need for repairs and maintenance and to enforce its own rights against the master landlord pursuant to the master lease (as opposed to taking on the master landlord's maintenance and repair duties and obligations).

If the subtenant takes over only a portion of the leased premises, generally speaking, the subtenant will assume the sublandlord's maintenance and repair obligations but only as they related to the smaller subleased premises. The sublease agreement would need to clarify that the sublandord would maintain and repair the other portions as failure to do so could materially impact the subtenant's occupancy of the subleased premises.

d. **RELEASE OF LIABILTY**: Is the sublandlord released from its liability and obligations under the master lease once the sublease takes effect?

Whether or not and to what extent the sublandord remains liable under the master lease is a concern under any transfer of lease interest. However, it's less of an issue in a sublease situation because the sublandlord does remain primarily liable to the master landlord under the master lease vis-à-vis privity of contract.

This in comparison with the alternative scenario of an assignment of lease interest wherein the parties are more likely to negotiate the extent in which the tenant may or may not be released from liability and its obligations to the master landlord under the master lease.

The sublandlord will want to make sure that the subtenant's indemnity obligations cover the sublandlord and the master landlord to the extent of the sublandlord's indemnity obligations under the master lease. The subtenant should request certain exclusions from its indemnification of sublandlord and the master landlord, including: (i) sublandlord's liability existing prior to the effective date of the sublease; (ii) obligations arising from any portion of the leased premises which is not part of the subleased premises; and (iii) environmental or other conditions pre-existing the effective date of the sublease.

e. **DEFAULT**: Any default by the subtenant under the sublease may trigger a default by the sublandlord under the master lease. Even if the subleased premises is less than the entire portion of the leased under the master lease, a default by the subtenant may trigger a default of the master lease and subject the sublandlord to all rights and remedies of the master landlord under the master lease. Accordingly, the parties should carefully consider its respective liability and limitations relative to the potential damage which may be incurred by the non-defaulting party.

Potential default by the sublandlord typically involves sublandlord's failure to enforce the master landlord's obligations under the master lease and the sublandlord's default under the master lease. The subtenant's main concern is that the sublandlord not default under the master lease as such default, even if unrelated to the subleased premises, could result in the termination of the sublease – through no fault of the subtenant. Thus, the subtenant should protect itself by negotiating into the sublease agreement, adequate rights and remedies, including potentially consequential damages. Further, a savvy subtenant would protect itself against a potential default by the master landlord, by incorporating into the sublease agreement an obligation for the sublandlord to use commercially

reasonable efforts to enforces its rights against the master landlord because the subtenant has no direct recourse and no privity of contract against the master landlord.

D. CONCLUSION

Although a sublease agreement may provide a subtenant with certain flexibilities, e.g., shorter lease term and ability to get into a rental more quickly than a direct lease with a landlord, there certainly are potential risks that a party should consider before entering into a sublease arrangement due to the fact that a subtenant would be entering into a pre-negotiated written contract in which it was not originally involved.

The foregoing ideas and recommendations discussed are based on general principles of law but it is worth noting that established rules regarding subleases vary by jurisdiction and are jurisdiction specific. So we would encourage you and any potential client of yours contemplating a sublease agreement to carefully perform the necessary due diligence specific to the applicable jurisdiction in which the subleased premises is located.