

Landlords, Should You Consent to That Sublease?¹

Given the current soft real estate market, many commercial landlords will, sooner or later, be presented with a request from a tenant that they consent to the sublease or assignment of a lease in their building. How should a landlord respond to this request?

- Understand what kind of transaction is proposed.

The first thing is to find out what kind of transaction is proposed. Despite the fact that the term, "sublease" is often used generically to refer to both, there are important legal distinctions between an actual *sublease* and an *assignment* of the lease. An assignment is the transfer by the tenant of all of its interest in the lease, i.e., all of the leased premises for the full unexpired term of the lease, and all other rights in the property. The assignee "steps into the shoes" of the tenant and becomes the new tenant. The assignee pays rent to and otherwise deals directly with the landlord, and the original tenant has no right to re-enter the premises if the assignee should default. Unless the landlord agrees to release the original tenant, however, it remains liable under the original lease, becoming essentially a guarantor.

By contrast, a sublease is a transfer of less than all of the tenant's interest in a lease. It may be a transfer of a portion of the premises, or all the premises for a portion of the remaining term, or a combination. The tenant retains the right to re-enter and re-possess the sublet premises upon the subtenant's default. The landlord-tenant relationship between the landlord and original tenant remains, and there is an *additional* landlord-tenant relationship between the tenant and subtenant. There is no direct legal relationship between the landlord and the subtenant. Unless the parties agree otherwise, the subtenant deals only with the tenant and pays rent to the tenant as its landlord, and the tenant deals with and pays rent to the landlord. The amounts of lease rent and sublease rent need not be the same.

The landlord's interests can be equally well protected with either form of transaction, so whether or not it wishes to have a direct legal relationship with the new occupant of the space may be the only significant factor driving its preference for one form of transaction or the other.

- Understand what the law requires.

There are two sources of the landlord's legal rights in this situation: the lease and the common or case law, which is the law developed by the courts deciding cases over time. Most leases will have a section devoted to assignment or subletting. They generally say that the lease may not be assigned or sublet without the landlord's consent, and they usually either say that landlord's consent may not be unreasonably withheld, or that the landlord may withhold consent in its sole discretion. When the lease does not say one way or the other, the common law requires the landlord to act reasonably. And even when the lease says that the decision is in landlord's sole discretion, if the tenant has defaulted or is about to default, the common law's

¹ [The June 16, 2001 issue of the CREJ contained Ms. Fox's article, addressed to tenants and potential subtenants, which discussed the legal considerations of entering into a sublease or assignment of leased premises. In this article, the landlord's concerns and interests are discussed.]

requirement that a landlord must act to mitigate (or minimize) its damages will "trump" the language of the lease and require the landlord to act reasonably.

Many leases give the landlord some additional rights when the tenant proposes an assignment or sublease. One such right is called a "right of recapture", and it provides that, if the tenant proposes an assignment or sublease, the landlord may choose to terminate the lease as to the portion of the premises which the tenant seeks to sublet or assign, freeing the landlord to deal directly with the proposed subtenant or assignee. Another right often found in leases gives the landlord the right to keep all or a portion of any rent premium, that is, the excess of the sublease rent over the lease rent. (Of course, given current market conditions, this right rather superfluous in most cases!) Still another common lease provision gives the landlord the right to be reimbursed by the tenant for some or all of the legal and other professional expenses it incurs in connection with evaluating the potential subtenant/assignee and documenting the transaction. The landlord should be aware of such lease provisions if they exist, and consider whether to exercise them.

- Get information about the proposed subtenant/assignee and consider the effect of the sublease or assignment.

In any case, it is usually in the landlord's best interests to act reasonably, regardless of what the lease says. If the tenant is about to go bankrupt or simply out of business, someone new to pay the rent beats no one paying the rent. And particularly at retail properties, empty spaces can lead to greater losses than simply the loss of rent from the particular tenant who seeks to sublet or assign its lease. The original tenant remains liable to the landlord in either case, unless the landlord agrees to release it, so the landlord's position is enhanced by now having two parties "on the hook" for the rent instead of one.

Since the landlord will legitimately ask for and receive financial statements and other information commonly requested of any tenant of the building, it may turn out, in many cases, that the proposed subtenant or assignee is much stronger than the one it replaces.

- What are valid bases for refusing to consent?

Nevertheless, there are some cases in which a landlord should not give consent. Two examples are when the proposed subtenant or assignee proposes a use for the premises which would violate an exclusive use right held by another tenant, or proposes a use prohibited by restrictive covenants governing the property. And there are cases which are less black-and-white but where the landlord's refusal to give consent would likely be held to be reasonable by a court. An example is where the proposed subtenant's use would, while not actually violating an exclusive right of another tenant, be a use which would adversely affect the "tenant mix" of a shopping center (e.g., too many bagel shops, an "adult" entertainment store in a family-oriented center, a video arcade in a center geared to upscale women's fashion). Another example would be a use which would strain available parking or significantly increase the need for lighting or other security measures.

What if a the proposed subtenant or assignee is financially weak or has little experience in its business? A court may reason that two weak tenants are better than one, and hold that a landlord's refusal to agree to a weak subtenant is therefore unreasonable. On the other hand, it may agree with a landlord who argues that another weak occupant of the premises could lead to continuing turnover and that refusal to consent to such a new subtenant or assignee is reasonable.

The landlord should review the sublease or assignment document, and may decide to refuse consent if it reasonably finds the proposed use or any other provision to be objectionable. In any event, a landlord who is inclined to refuse consent is well advised to (a) discuss his decision with his attorney, because of the ever-present possibility that the basis for the decision will be challenged in court by either the tenant or the proposed subtenant/assignee, and (b) document all reasonable bases for the refusal in a written letter to the tenant, delivered in accordance with the lease's requirements for giving of notice.

- Protect yourself.

The sublease or assignment-of-lease should cover the following matters, for the protection of the landlord. If they are not covered there, a separate Landlord's Consent document, executed by landlord, tenant and subtenant/assignee, may be drafted which says that landlord's consent is given upon the conditions stated in the document.

- In a sublease situation, there should be an acknowledgment by the subtenant that it has reviewed and is familiar with both the sublease and the original lease (often referred to as the "master lease"), and in an assignment situation, the assignee should confirm that it has reviewed and is familiar with the lease which it is accepting pursuant to the assignment.
- It is wise to have the assignee or subtenant specifically acknowledge lease and sublease insurance provisions, agree to name the landlord as an additional insured under all policies, and to obtain a waiver of subrogation in favor of the landlord.
- The consent should describe any alterations that are being done to the premises in connection with the sublease or assignment (and who is paying for them, etc.), and should have the subtenant or assignee specifically acknowledge that no further alterations may be done without landlord's written consent.
- There should be a prohibition of any further assignment or subletting, or a statement that landlord's consent to the instant sublease or assignment shall not be deemed to waive the requirement for landlord's consent to any further subleasing or assignment.
- The landlord should require that the sublease or assignment document may not be amended without landlord's consent.
- It is wise to include a requirement that any notices between the tenant and its subtenant or assignee must be simultaneously copied to the landlord.
- While it strikes this writer as over-reaching in most circumstances, some landlords require additional security, such as an additional security deposit, an additional guaranty or a letter of credit supplied by the subtenant or assignee.
- In a sublease consent, it may be advisable to specifically prohibit the subtenant from doing anything which would cause a violation of the master lease, notwithstanding anything to the contrary in the sublease.

- A landlord may or may not wish to provide that any options (to renew, expand or terminate early, for example) in the lease are terminated upon the assignment or sublease. (Be careful; consider whether a court would consider this reasonable if it were challenged.)
- A sublease is automatically terminated upon termination of the master lease. The landlord may therefore want the subtenant to agree that if the master lease is terminated, the landlord has the option to assume the sublease and convert it to a direct lease. (Expect the subtenant to want a reciprocal right, however.)
- In a consent-to-sublease, it is wise to have the consent document state that, notwithstanding the agreements contained in the consent document, there is no privity created between landlord and subtenant unless and until the landlord exercises any right to assume the sublease or the parties otherwise agree, and that the landlord has no direct obligations to the subtenant.
- Consider the alternative.

There is an alternative to simply giving or withholding consent to a sublease or assignment. As mentioned, the lease may give the landlord a "right of recapture", freeing it to terminate the lease and enter into a direct lease with the proposed subtenant/assignee. Even if this right is not given to the landlord in the lease, the three-way negotiations among the landlord, tenant and proposed subtenant/assignee may lead all concerned to the conclusion that lease termination and creation of a new lease between the landlord and the party originally proposed as a subtenant or assignee is in everyone's best interests. This approach particularly makes sense if the proposed tenant/assignee wishes to have a lease term longer than the balance of the original tenant's lease term or to take more space than the original tenant's premises. Because many tenants are eager to be released from any further obligations under their leases, a landlord may find the tenant willing to contribute cash, furniture or telecommunications or other equipment to facilitate this approach. And the additional benefit of this approach is that it is often much simpler to document than either a sublease or assignment with accompanying landlord consent.

- Document the transaction completely.

Whatever the form of the transaction, appropriate and complete documentation is in every party's best interests, and the parties' attorneys should be engaged to do it properly.

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