

Office Users: What to Know When Considering Subleasing

It is certainly no secret that there is a lot of office "sublease space" on the market. While the term, "sublease space" is commonly used as a generic marketing term, the actual legal form of these transactions may be either a sublease or an assignment of the lease. In either case, both tenants who are disposing of excess space and potential subtenants/assignees should be aware of the legal implications and risks of such transactions.

- Sublease vs. Assignment. There are important legal distinctions between a genuine 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 lease, becoming essentially a guarantor. If the assignee defaults under the lease and the tenant has to make good on those original lease obligations, the tenant's only remedy against its assignee will be a lawsuit for reimbursement.

By contrast, a sublease is a transfer of *less than all* of the tenant's interest in the 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 (lease rent and sublease rent need not be the same).

- Considerations for tenants with excess space. The tenant with space it no longer needs, wants or can afford should first of all review its lease or, better yet, have its real estate attorney review it. There are several places in the lease where issues relating to subleasing or assignment of the lease are commonly addressed:

- The "assignment/subletting" clause. Most commercial leases have a section which specifically deals with the tenant's right to assign or sublet its premises. Usually, these clauses require landlord's written consent to an assignment or sublease. Some leases require the landlord to be reasonable, while others allow it to be arbitrary (although other legal considerations may require it to be reasonable despite such language). If the lease is silent on this point, the landlord must act reasonably. There are usually many other provisions such as requiring submission of the subtenant/assignee's financial statements and the sublease/assignment document, fees or reimbursement of the landlord's expenses, and various deadlines. It may give the landlord a right to all or part of any consideration paid by the subtenant/assignee, including any sublease rental over the original lease rental, or it may allow the

landlord to terminate the lease as to the part of the premises which the tenant seeks to sublet or assign so that it may deal directly with the proposed subtenant/assignee.

- The options clause. The section of the lease which gives the tenant the right to renew the lease term, or an option to expand, or an option to terminate or reduce its space may provide that such rights automatically terminate upon a sublease or assignment. If so, the tenant will need to be careful that it does not mislead the subtenant/assignee into believing that the options will be available to it.
- The "permissible use" clause. The "permissible use" section should be checked for restrictions on any new uses by an assignee/subtenant.

Additionally, any lease guarantor should review the terms of his or her guaranty to determine how an assignment or sublease will affect his or her obligations.

The tenant is well-advised to hire an experienced commercial real estate broker. Besides marketing the premises and finding a potential subtenant/assignee, the broker can advise on market rents and realities, prepare the landlord and obtain a copy of any consent form the landlord may require, negotiate with the subtenant/assignee and landlord, and interface with attorneys, space planners, subtenant brokers and others. Because of access to strong potential subtenants and knowledge of various strategies and negotiating points, use of an experienced broker may increase the tenant's chances of obtaining a release from the lease.

Although the deal finally struck will be the product of the three-way negotiation among tenant, proposed subtenant/assignee and landlord, the tenant's first choice for the form of the transaction will be an assignment accompanied by the landlord's release of the tenant (sometimes the tenant can contribute financially or otherwise to the transaction in such a way as to obtain a release). The second choice will be a sublease (because the tenant would be able to re-enter the premises and look for a new subtenant if the subtenant should default) and the third will be an assignment in which it is not released. If the last choice cannot be avoided, a tenant might be able to get its assignee to give it some sort of security for the assignee's obligation to perform, such as a guaranty or letter of credit.

- Considerations for potential subtenants/assignees. The company considering taking sublease space is also well-advised to work with a good broker and attorney. The lease should be reviewed carefully. Besides checking on the tenant's ability to assign or sublease, and whether all of the rights in the lease will transfer, the potential subtenant/assignee must understand all of the obligations it is assuming. Whether or not the transaction takes the form of a sublease or assignment, the subtenant will have only the rights stated in, and all of the obligations of the lease, except to the extent the landlord may agree to modify them.

Ordinarily an assignment is more advantageous to a proposed subtenant/assignee than a sublease because, with a sublease, even if the subtenant performs its obligations perfectly, if the tenant/sublessor should default under the original lease and the lease therefore is terminated, the subtenant will be subject to eviction. Market realities often dictate, however, that it be content with a sublease. In such cases, the subtenant should investigate the creditworthiness of its sublandlord and negotiate with the tenant and landlord for at least two protections: (1) that the subtenant may make rental payments directly to the landlord for the account of the tenant, and

(2) that the landlord agrees that, if the lease is terminated for any reason, the landlord will recognize the tenant as its tenant pursuant to the terms and conditions of the sublease.

- "The third alternative". In the process of the three-way negotiation among the tenant, potential subtenant/assignee and landlord, there is a third alternative structure to the transaction which the parties should consider. This would be a lease termination agreement between the landlord and tenant, and a direct, new lease between the landlord and the party who was the potential subtenant/assignee. This is a much "cleaner" form of transaction for everyone concerned, although the negotiations to reach this point may be just as complicated.
- Documentation. It is in the best interests of all parties to have legal counsel involved in the documentation of the transaction, regardless of its form. For an assignment or sublease transaction, the documents will include the assignment or sublease, the landlord's consent, and a lease amendment to reflect an additional party to whom notices should be sent and any modifications to which the landlord may have agreed. Other documentation may include guarantees, modification of existing guarantees, bills of sale (and perhaps financing documents) for the sale of personal property and letters of credit. The documents should deal with numerous issues, such as the respective rights and obligations of the parties in connection with the annual operating expense reconciliation and any resulting overpayments or shortfalls; the value of the tenant's furniture, fixtures, equipment or improvements; any alterations to the premises, exercise of options, release or continuing obligation of guarantors. Other issues to be covered include transfer of any security deposit, warranties and indemnities among the parties, signage and payment of brokerage fees. If the "third alternative" is used, there will need to be a lease termination agreement and the new lease, and many of the same issues will have to be addressed.

In summary, dealing in "sublease space" can be a win-win situation business-wise for everyone concerned, but doing it right is just as important with this type of transaction as any other real estate transaction.