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Overcome the Five Pitfalls of Subleases

By Natalie Dolce



Tuan

SAN FRANCISCO-GlobeSt.com recently chatted with locally based Leon Tuan, a partner in Stein & Lubin LLP, about what he calls the "five pitfalls of subleases" and how to overcome them. In the commercial real estate area, Tuan represents investors, developers, landlords and tenants in buying, selling, developing, leasing and financing a wide variety of properties, including office buildings, shopping centers, apartment complexes, industrial properties and mixed-use projects. In the real estate finance area, Tuan represents institutional and private lenders in originating acquisition, construction and permanent loans, and also advises lenders in loan restructurings and loan workouts.

According to Tuan, large amounts of sublet space have come on the market during the current economic downturn, usually at discounted rates. And while he says subleasing can be an attractive and cost-saving option, "it is not without its drawbacks and does not usually offer the same protections as a direct lease." Below are five significant pitfalls that are associated with subleases, along with Tuan's suggestions for managing the risks.

Reliance on the Sublandlord

Tuan: A subtenant relies on the sublandlord (the original tenant) to pay all of the rent due and perform all of the other obligations owing under the master lease. If the sublandlord defaults under the master lease, this could lead to a termination of the master lease and the sublease.

A subtenant can try and eliminate this risk by seeking a non-disturbance agreement from the master landlord, where the master landlord agrees that if the master lease terminates due to a default by the sublandlord, the master landlord will continue to recognize the rights of the subtenant to occupy the sublet space. In reality, master landlords rarely give non-disturbance to subtenants, particularly since the amount of the sublease rent is likely well below the amount of the rent under the master lease.

A subtenant should, however, at least try and get notice and cure rights from the master landlord with respect to any defaults by the sublandlord under the master lease. This way, the subtenant can evaluate whether it makes economic sense to cure a default by the sublandlord in order to preserve its rights to the sublease space. A subtenant should also carefully evaluate the creditworthiness and business prospects of the sublandlord so that it can make an informed assessment of whether the sublandlord is likely to stay in business for the duration of the sublease term and will be able to pay the rent due under the master lease for that period.

A subtenant should also seek representations and warranties from the sublandlord and the master landlord to validate whether the sublandlord is in default, whether there are any current disputes under the master lease, to confirm the amount of rent and pass-throughs, and to ensure that the subtenant has reviewed a true and complete copy of the master lease and all lease modifications.

Finally, a subtenant should expressly prohibit the sublandlord from voluntarily terminating the master lease prior to the end of the sublease.

Performance by Master Landlord

Tuan: While a sublease creates a legal relationship between the sublandlord and the subtenant, a sublease generally does not create any legal relationship between the master landlord and the subtenant. So if the master landlord fails to fulfill its maintenance and repair obligations under the master lease, or if it stops providing building services, how will the subtenant be able to protect itself?

A subtenant should require the sublandlord to enforce its rights under the master lease if, for example, the roof leaks or the HVAC system breaks down and the master landlord fails to fulfill its repair obligations. A subtenant may also want to be able to require the sublandlord to assign its enforcement rights under the master lease. The sublandlord may not be motivated to spend its time and money to enforce a default by the master landlord, so an assignment of these enforcement rights will allow the subtenant to take steps directly against the master landlord in order to protect its interest in the sublease space.

A subtenant might even seek a termination right if the master landlord fails to perform an obligation or provide a service under the master lease, and this failure materially interferes with the subtenant's use of the sublet space.

Master Lease Issues

Tuan: Since a sublease is subject to the terms of the master lease, a subtenant needs to carefully review the master lease to ensure that it can live with those terms.

For example, use issues can be very complicated under a retail lease. The master landlord is often bound by pre-existing exclusive use and prohibited use restrictions that have been given to existing retail tenants and that must be parsed through by the subtenant to ensure that its use will not trigger any conflicts.

A subtenant should also pay particular attention to master lease clauses relating to building or common area services and charges, insurance and indemnity, alterations, surrender and restoration, and holdover to ensure that they are acceptable to the subtenant.

Sharing Space

Tuan: If the sublease is for only a portion of the space under the master lease, the subtenant needs to thoroughly evaluate how it will partition the sublet space from the balance of the premises and make the sublet space operational. Consider the location and configuration of entrances, exits and pathways to the sublet space, access to elevators or loading docks, and whether utility and HVAC systems have to be submetered, re-routed, or reconfigured. The subtenant should also consider how to allocate access and costs with respect to any shared spaces, such as conference rooms or server rooms, and shared services, such as janitorial services.

Surrender and Holdover

Tuan: If a subtenant makes alterations to its sublet space, it should focus on its removal obligations at the end of the sublet term, the level to which the sublet space should be restored, and whether the sublandlord or master landlord should decide the extent and level of restoration. The subtenant should ensure that its restoration obligations are limited to the condition existing when the subtenant took possession of the sublease term, and not to the condition existing as of the commencement of the master lease term.

A subtenant should also be aware that if it holds over in the sublease space, it may trigger holdover exposure to the sublandlord as to the entire space covered under the master lease. The sublandlord will seek to pass through this exposure to the subtenant, so the subtenant should make sure that it surrenders possession of the sublet space on time unless it has cleared the terms of the holdover with the sublandlord and the master landlord.

Conclusion

Tuan: While a subtenant may be able to realize significant rent savings on sublet space as compared to comparable space on a direct lease basis, subleases pose additional business risks that the subtenant must evaluate and try to address in order to protect its interests. The subtenant

must work with the sublandlord and the master landlord to identify and manage these risks before it signs a sublease.