

## Subleasing Concerns

By Doug Van Gessel and Katharine Allen

Sheppard, Mullin, Richter & Hampton LLP

February 2009

The sudden and dramatic softening of the local commercial real estate market has led to a flood of sublease space on the commercial real estate market. Although this flood represents a potential economic windfall for those seeking to occupy commercial space, there are a number of potential legal pitfalls and practical problems commonly overlooked by potential sublessors and sublessees, who often merely rely on boilerplate sublease forms when entering into subleases.

The most basic pitfall involves the legal status of the parties to a sublease. Its often a surprise to sublessors to realize that they are not somehow released from their obligations under the master lease, which continue in full force and effect, notwithstanding the sublease. And a sublessee's rights pursuant to a sublease are entirely dependent upon the existence of the master lease for the space. A landlord has no obligation to provide services to the subtenant. If the master lease terminates, so does the sublessee's rights to the sublet space. Therefore, the sublessee must protect itself against the potential loss of its sublet space and the associated costs invested in the sublet space.

Another basic pitfall involves the problems inherent in a sublessee inheriting the terms of a master lease which has been negotiated by its sublessor. Most of the terms of a sublease are incorporated by reference from the master lease. However, the terms of the master lease may be entirely inappropriate for the use contemplated by the sublessee, or they may reflect the balance of negotiating power of the white-hot real estate markets of recent years, as opposed to the softening market of today.

While the parties often assume that a sublease will be easier to draft than a master lease, since most of the terms for occupancy are already in place, that is not always true, since a sublease raises many of its own issues. This article describes these issues in greater detail, and attempts to provide practical solutions designed to allow all of the parties to a sublease to successfully complete the transaction.

### *Sublessor Concerns*

First, it is important for the parties to determine whether or not the master lease allows the sublease to occur. The landlord's consent is almost always required for an assignment or a sublease. In California, most leases state that the landlord's consent to a sublease is not to be unreasonably withheld. For a lease in California entered into after September of 1983 which does not state the standard for a landlord's consent to a sublease (i.e., whether the landlord may withhold its consent to a sublease in its sole discretion, or the landlord cannot unreasonably withhold its consent to a sublease), California law implies that the landlord's consent may not be unreasonably withheld. Factors generally recognized by

Prepared by:

Doug Van Gessel, Partner | 415.774.2989 | [dvangessel@sheppardmullin.com](mailto:dvangessel@sheppardmullin.com)

Katharine Allen, Associate | 415.774.2903 | [kallen@sheppardmullin.com](mailto:kallen@sheppardmullin.com)

Sheppard, Mullin, Richter & Hampton LLP

[sheppardmullin.com](http://sheppardmullin.com) | [realestateandconstructionlawblog.com](http://realestateandconstructionlawblog.com)

the courts as reasonable concerns of the landlord include the net worth and business reputation of the sublessee and the proposed use of the sublease premises by the sublessee.

It is important to review the master lease, however, because less obvious requirements may be stated therein which the landlord may apply in order to withhold its consent to a sublease. For instance, many leases specify that a tenant may not sublease space to an existing tenant in the building or project in which the leased premises are located, or to any entity with which the landlord has negotiated a potential lease within the last six months. Some leases also specify that the tenant may not enter into a sublease at less than the fair market value rent for the space or the rent otherwise being offered by the landlord in the building at the time of the request for consent to the sublease. Given that sublease rents are often less than those of direct lease transactions, such a requirement may be difficult to surmount. The parties should also review the master lease in order to review the restrictions on use of the premises in order to ensure that the sublessee's proposed use of the sublet space is not in conflict with the master lease. Leases typically provide that any rights of the tenant to extend the lease term or expand the premises do not apply to sublessees, which may be a deal-breaker for the potential sublessee.

Many leases also provide a so-called recapture right of the landlord, allowing the landlord to respond to a request for a sublease by instead terminating the lease with respect to the space proposed to be subleased. If such a recapture right exists, it is important to determine the time period in which the landlord may exercise the right, and to refrain from spending any significant amounts with respect to the sublease until it is certain that the recapture right will not be exercised.

## *Sublessee Concerns*

### Terms of Master Lease

Given the dramatic swing in the commercial real estate leasing market in the past months, it may make sense for a sublessee to try to renegotiate some terms of a master lease rather than living with the terms that its sublessor was forced to accept in the pro-landlord market of the past few years. Although these subjects will be discussed in greater detail below, areas of particular concern to a sublessee often concern late fees, default rates of interest, the ability to make alterations to the sublease premises, the allocation of responsibility for capital expenditures and holdover rent provisions of the master lease passed-through to the sublessee.

### Terms of the Sublease

Once the sublessee has determined that the terms of the master lease will allow the sublease to occur, and that incorporation of the terms of the master lease will be acceptable to the sublessee, the terms of the sublease itself must be negotiated. The following is a list of some of the issues requiring the attention of the sublessee:

1. **Definition of the Sublet Space.** Although the portion of the premises subject to the master lease which is to be subleased as sublet space is often shown on a floor plan attached to the

Prepared by:

Doug Van Gessel, Partner | 415.774.2989 | [dvangessel@sheppardmullin.com](mailto:dvangessel@sheppardmullin.com)

Katharine Allen, Associate | 415.774.2903 | [kallen@sheppardmullin.com](mailto:kallen@sheppardmullin.com)

Sheppard, Mullin, Richter & Hampton LLP

[sheppardmullin.com](http://sheppardmullin.com) | [realestateandconstructionlawblog.com](http://realestateandconstructionlawblog.com)

sublease, it is not uncommon for the parties to fail to understand fully whether the sublet space includes, or whether the sublessee at least has non-exclusive use rights to, lobbies, common areas, plazas, patios and lunchrooms servicing both the premises retained by the sublessor and the sublet space. Also, it is currently a common practice for sublessors to either lease or sell their furniture and/or other equipment to their sublessees. In any particular sublease, the parties should determine whether the sublessor desires to sell or lease such furniture and/or other equipment at the time of the sublease. If the sublessor sells such furniture and/or other equipment to the sublessee, the sublessor should deliver a bill of sale which should state that the sublessor is the owner of such items, and that the items are not currently encumbered by any liens. The sublessee should have the free right to remove such furniture and/or other equipment from the sublet space at any time.

2. **Condition of the Sublet Space.** Is the sublet space to be delivered on an “as-is” basis, or is it to be built-out by the sublessor or the landlord? There are special issues associated with the landlord’s control of the build-out and/or use of tenant improvement allowance for the sublet space. If the sublessee is subleasing space which has not been substantially completed by the landlord, or is given a portion of the tenant improvement allowance that is provided to the sublessor by the landlord under the master lease for completion of the sublessee’s improvements, it is important for the sublessee to obtain estoppel certificates or other statements affirming the current status of construction and describing the conditions that will be imposed on the sublessee’s use of the tenant improvement allowance for completion of the sublessee’s tenant improvements.

3. **Sharing Functions of the Leased Premises.** It is important for the sublessor and the sublessee to allocate responsibility with respect to services and utilities that are provided jointly to both the sublessor’s premises and the sublet space. Are the utilities that are provided to the sublet space separately metered? If not, the parties should determine whether a sub-meter should be installed and, if so, at whose expense. In the alternative, the parties may determine a manner for the equitable allocation of the cost of the utilities. To the extent that the sublessor has the right as the tenant under the master lease to choose certain utility providers, the sublessee might consider requiring a say in that choice. The sublessor and the sublessee should also consider how to approach issues related to the cost of after-hours HVAC or electrical systems.

4. **Landlord’s Obligation to Provide Services for a Sublet Space.** Typically, a master lease specifies that the landlord is to provide building services and utilities to the tenant. These services include plumbing, electricity, water, janitorial service and maintenance, and repair of common areas. However, because a sublessee does not have a direct contractual relationship with the landlord, it has no redress against the landlord for the landlord’s failure to provide such services or utilities to the sublessee or other occupants of the building.

Attorneys will often negotiate over whether the sublessor must use “diligent,” “reasonable” or “best” efforts. In any event, it is important for the sublessee to attempt to provide in the sublease that the sublessee has the right to sue the landlord in the name of the sublessor in order to ensure that such services and utilities are provided to the sublet space.

5. **Protecting Sublessee from a Sublessor's Default.** A sublessee should obtain a good understanding of the financial strength of any proposed sublessor. Does the sublessor have sufficient financial strength to perform its obligations under the master lease? Will the sublessor be paying more rent under the master lease than the sublessee will pay under the sublease? If so, what, if anything, should be done to assure the sublessee that the sublessor is in a financial position to pay the difference in rent?

The following are strategies commonly used by sublessees to protect themselves against defaults by sublessors under master leases:

First, the sublessee might request a recognition agreement from the landlord pursuant to which the landlord agrees to recognize the sublease as a direct lease between the landlord and the sublessee in the event that the tenant defaults under the terms of the master lease. Landlords are historically reluctant to provide recognition agreements, because recognition agreements interfere with landlords' ability to play the market in the hope of an increase in fair market rental values.

If the sublessee is unsuccessful in obtaining a recognition agreement, it should at least attempt to obtain an agreement from the landlord that the landlord will simultaneously deliver to the sublessee a copy of any default notices that the landlord provides to the tenant under the master lease and that the sublessee will have the right to cure such defaults.

In addition, or in lieu of a recognition agreement, a sublessee might also bargain for the ability to pay the sublease rent directly to the landlord in order to defeat the potential diversion of the sublessee's rent. The sublessee should obtain an indemnity from the sublessor for damages resulting from the sublessor's defaults under the master lease.

Also, the sublessor should covenant to promptly provide the sublessee with any notices of defaults and other matters received by the sublessor. The sublessor should also agree not to amend the master lease in any manner that would adversely affect the sublessee.

6. **Protecting Sublessee Against a Landlord's Default.** Because the sublessee's rights to the sublet space are dependent upon the existence of the master lease, the sublessee also has an interest in making sure that the master lease is not terminated due to a failure of the landlord (i.e., the owner of the building) to pay when due any debt encumbering the sublet space. If the landlord fails to pay such debt, and the lender forecloses as a result, any lease of the property which was executed after the loan was made may be terminated by law, unless the tenant in question has received a non-disturbance agreement from that lender promising that the lease will survive the foreclosure so long as the tenant is not in default under the lease.

Subsequent to a foreclosure, a sublessee's interest in its sublease will rise or fall with the status of the master lease. Therefore, a sublessee should make sure that such a non-disturbance agreement

has been granted to the sublessor. This protection is especially important as the commercial real estate market continues to soften.

7. **Protection from Termination of the Master Lease.** Again, because the existence of the sublease is dependent upon the existence of the master lease, the sublessee will want to prevent the master lease from terminating for any reason. The sublease should contain a covenant of the sublessor not to terminate the master lease pursuant to a separate agreement between the sublessor and the landlord. The master lease may also provide that the sublessor, as the tenant under the master lease, has the right to terminate the master lease under certain circumstances if the premises are affected by casualty or condemnation, or if there is an interruption of services to the premises. The sublessee should try to control that decision to terminate, if at all possible.
8. **Surrender Obligations.** If the sublessee will perform an initial build-out of the sublet space, the sublessee should consider incorporating an agreement into the sublease regarding whether or not such build-out must be removed at the end of the term of the sublease. The sublease should also include a provision stating that the sublessee is not required at the end of the term of the sublease (and the lease) to remove any alterations made by the sublessor, or which were already in the sublet space at the time the sublease term began.
9. **Alterations.** If the sublessee already has plans for the alterations and intends to build out the sublet space, the sublessee should obtain approval of those plans from the landlord and the sublessor at the time the sublessee enters into the sublease in order to eliminate the risk of later disapproval by the landlord and/or the sublessor. If the master lease provides that the landlord is entitled to construction management fees in connection with any alterations to the premises, such fees should not be incorporated by reference into the sublease (construction management fees should not be paid by the sublessee to the sublessor).
10. **Parking.** The sublease should discuss the sublessee's rights to use the parking spaces that are provided by the master lease (or by a separate parking agreement). The sublessor and the sublessee should consider how they will police the parking areas to ensure that neither party is exceeding its share of parking rights.
11. **Signage.** The sublease should discuss what rights, if any, the sublessee has to the sublessor's signage on the building directory, on the door to the sublet space, and, if applicable, to the premises. Sublessee might also consider having both landlord and the sublessor pre-approve any sign actually contemplated by the sublessee.

Current market conditions provide users of space a rare opportunity to sublease space at reduced rental rates. However, the same market conditions have created an unprecedented number of potential legal and practical pitfalls for the unwary. Reliance on a boilerplate form sublease in order to sublet a meaningful amount of space is a common way to suffer such pitfalls.