

## IN THE SPOTLIGHT

## Subleasing Benefits And Risks

By Lars Andersen

Current adverse economic conditions are causing many tenants to consolidate and reduce their space requirements given downsizing and reductions in force. The result is that significant amounts of office space are now becoming available for subleasing as prime tenants seek sub-rent income to help cover their prime rent obligations to their landlord.

It is important to remember that a subtenant's occupancy rights are completely derivative of the lease rights that a prime tenant has. Thus, a subtenant can never get any better or more comprehensive rights than that which its sublandlord (the prime tenant) has under the prime lease. In practice, though, a subtenant's rights are actually more limited than those enjoyed by the prime tenant.

### WHAT'S THE UPSIDE OF LEASING YOUR SPACE VIA A SUBLEASE?

#### *Benefits of Subleasing*

Many office space users find subleasing an attractive alternative for a variety of reasons, including:

- Subrent costs are typically significantly discounted as compared

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with prime rent rates in a given market or submarket.

- Sublease durations are usually shorter than that which landlords require of a prime tenant. This can give a subtenant greater flexibility in meeting its changing space requirements, as well as an opportunity to fulfill for space needs without the long-term financial commitment required under a prime lease.
- Sublet space is usually already built out, so if the subtenant is OK with the existing configuration of the space (office layout, window exposure, reception area, conference rooms, etc.), the up-front costs of interior tenant improvements (with the exception of demising walls to separate out the subtenant's area, if required) can be avoided, and move-in can be done in a shorter time frame.

### WHAT'S THE DOWNSIDE OF SUBLEASING FOR YOUR SPACE NEEDS?

#### *Risks of Subleasing*

There are some notable downsides to being a subtenant, among these:

1. A subtenant's occupancy rights "rise and fall" with the fortunes of its sublandlord (the prime tenant). If that prime

tenant does not make its prime rent payments, the landlord may pursue an action for breach under that lease, and the resulting termination of the prime lease will abruptly end the subtenant's continuing occupancy rights. Obviously, this can put the subtenant in an unexpected, sudden and even disastrous position where that subtenant has to scramble to find new space. Among the resulting "pain points" for the subtenant are disruption of its operations, breaks in continuity of client service, loss of credibility with clients due to being in limbo over its office presence, and loss of employee morale. For retail operations there is also the added loss of location goodwill. Unfortunately, the history of economic downturns is full of instances where financially troubled tenants have "scooped" the subrents they receive and then not remitted those funds to the landlord toward paying their own rent obligation.

2. Subtenant occupancy risk also can occur where the prime tenant decides (due to consolidation, or cost reduction imperatives) to negotiate an early termination of its prime lease.

3. Landlords typically avoid any "privity of contract" with underlying subtenants. Instead they will only sign a "Sublease Consent" that merely acknowledges that they will tolerate (permit) the subtenant's occupancy subject to all terms and obligations appearing in the prime lease.

4. The lack of "privity of contract" with the landlord means that if the subtenant has any issues with the operation or maintenance of the building, it will be forced to coordinate the complaint and problem resolution through its sublandlord (the prime tenant). The prime land-

lord owes no direct duty to the subtenant. Thus, after subleasing space (especially when subleasing an entire premises to a subtenant), that sublandlord may or may not be motivated or inclined to assist actively and promptly with such problem resolution.

5. Since a sublease duration (term) can only extend to the end of the remaining "tail" period of the existing prime lease, subtenants will typically have a shorter period of assured occupancy as compared against prime lease terms, and thus will have to deal with the disruption of more frequent moves of their operations. It is notable, though, that there are some business models that prioritize lease cost containment so highly that they anticipate moving from one sublet premises to the next on a periodic basis.

### HOW CAN YOU PROTECT YOURSELF AS A SUBTENANT?

Here are actions you can take to protect yourself as a subtenant:

- Make sure that the landlord has signed the required "Sublease Consent." This separate document (different from the sublease itself) is almost always required by the prime lease provisions, and evidences the landlord's approval of the subtenant's occupancy in the space. With a few exceptions, a subtenant cannot legitimately get possession of the sublease premises without this signed consent. In some cases, though, a prime lease may waive the need for consent where the subtenant is a subsidiary or affiliated entity of the prime tenant — thus, in some unique instances it may be possible to structure common ownership with a proposed subtenant in order to take advantage of such consent requirement "carve-outs."
- Make sure to review the prime lease document (and any existing amendments) carefully for provisions that can make your occupancy as a subtenant difficult or risky (e.g., early termination provisions, use restrictions, etc.). If at all possible, subtenants should get an affirmative rep-

resentation in the consent signed by landlord that its intended use is expressly permitted.

- Have the sublandlord warrant in the sublease that it will not enter into any modification or amendment to the prime lease that would adversely affect the subtenant's rights and occupancy under the sublease. If there is an early termination provision in the prime lease, make sure your sublandlord warrants that it will not exercise that right.
- Provide in the sublease that the sublandlord has a duty to provide the subtenant with copies of any and all amendments to the prime lease, whether occurring before or after the signing of the sublease.
- Provide in the sublease that the sublandlord has a duty to assist the subtenant diligently and promptly in resolving with the landlord any issues the subtenant has with that landlord's operation of the building or property. If the sublease is to be for the entirety of the prime premises for the rest of the prime lease term, then seek to make the transaction an assignment, not a sublease. As an assignee, your relationship will be directly with the prime landlord, and your occupancy will not be dependent on hoping that your sublandlord faithfully remits your subrents on to the prime landlord.

In the case of retail subleases, subtenants need to be especially careful to confirm that their intended use is permitted under the prime lease. Many times retail leases allow only for an exact, described type of use (limited to offerings of specific products, services, etc.) of the original tenant, and do not permit other uses.

In rare instances the subtenant can get the benefit of a "non-disturbance right" provision in the Sublease Consent signed by the landlord. This clause expressly provides that should the prime lease terminate early for whatever reason (prime tenant not paying its rent, etc.) the landlord will still recognize the subtenant's continuing right of occupancy (as per the Sublease) in exchange for the subtenant's

payment of subrents directly to the prime landlord. A subtenant non-disturbance right is of great protection, but landlords rarely agree to them because they want to preserve the freedom to get all occupants out of the premises at termination of the prime lease, and then relet the space to a new prime tenant.

Especially in cases where a prospective subtenant looks to take the entirety of the subject space under the prime lease, that subtenant may want to consider approaching the prime landlord (in concert with the prime tenant), to see if there is a chance to negotiate an early termination of the existing prime lease, with the simultaneous assumption of a new lease. Whether such an opportunity exists depends on current market rents (and how they compare with scheduled rent rates under the existing lease), but where there is a relatively short duration left (*i.e.*, less than two years) under the existing lease term, landlords are much more inclined to come to the bargaining table on this point.

### CONCLUSION

Subleases may offer real benefits for certain users of office or retail space, and for their lessors. However, all prospective subtenants are well advised to seek assistance of an experienced commercial leasing attorney when considering and negotiating their sublease and the form of landlord's consent. The "devil is in the details" when it comes to your business's sublease (and the overriding prime lease), and relatively innocuous looking fine print may later have unexpected economic and operational consequences down the road. Your leasing attorney can also be a great asset in later years when dealing with interpretations of the sublease and other issues that come up with your sublandlord and/or the prime landlord.