

**SUBLEASING ISSUES  
FOR SUBLANDLORDS AND SUBTENANTS**

***The sudden collapse of prestigious firms such as Heller Ehrman and Lehman Brothers, plus the disappearance of financial giants such as Merrill Lynch, Wachovia and Washington Mutual, will flood the office market with hundreds of thousands of square feet of subleasing space.***

***If your firm is considering entering into the subleasing market whether as a Sublandlord or as a Subtenant, then consider the following:***

**KEYS DIFFERENCES BETWEEN A LEASE AND A SUBLEASE**

1. A Sublease exists only as long as the Master Lease is in effect. If the Master Lease terminates due to the default of the Sublandlord or pursuant to an agreement between the Sublandlord and Master Landlord, the Sublease terminates absent a separate agreement between the Master Landlord and the Subtenant.
2. A Sublease is not necessarily simpler than a Lease. The parties often assume that the documentation will be easy since the Lease is already in place. Yes and no. Yes, most likely the parties will not be negotiating operating expense definitions and casualty, condemnation, and other lease provisions. On the other hand, a Sublease involves the coordination of at least three parties and the drafting of new documents in light of pre-existing obligations and perhaps defaults. Even if the Sublease document is short and simple in the end, the process of achieving that simplicity may be complicated.
3. A Subtenant has no direct rights against the Master Landlord. If the Master Landlord commits a default, such as failing to provide utilities, then a Subtenant may not have any direct rights against the Master Landlord, unless the parties have otherwise agreed in writing.
4. A Sublease does not release the Sublandlord from its obligations under the Master Lease. A Sublandlord could be liable for defaults and damages caused by its Subtenant.
5. Sublease rental rates are typically lower than market rental rates for space directly leased from the Master Landlord.
6. Extension and expansion rights are usually not transferred to a Subtenant.

## SUBLANDLORD CONCERNS

1. **Calculate your losses.** Assuming the sublease income will be less than your payment obligations under Master Lease, calculate your expected losses, including brokers' commissions, down time and build out costs.
2. **Meet with your Master Landlord before you go to market.** No landlord wants to learn through rumors or the newspaper about space in its building going out to the sublease market. Discuss your situation with your Master Landlord early in the process.

If your space is not highly marketable for subleasing (too small, too large, too short a remaining term, or your financial situation is shaky), then try to team up with the Master Landlord to market the space on a direct lease basis. You would be liable for any shortfall for the period of your Lease, but you may be able to present a better offer to the market.

You may want to approach the Master Landlord with an offer to terminate the Lease for a lump sum payment. Some Master Landlords will accept such an offer up front, particularly if the Sublandlord is financially weak and may not be in a position to pay at a later date. In most cases, however, the Master Landlord will wait until an actual subtenant or new tenant is in place so that any shortfall can be determined. A one-time, financial hit may make sense for your company. And it would keep you out of the subleasing business and focused on your primary business.

Discuss with your Master Landlord what financial criteria it will apply to potential Subtenants. Many Master Landlords balk at consenting to a Sublease with a financially weak Subtenant, particularly if the Sublandlord's financial condition is also compromised. The Master Landlord does not want to risk dealing with two bankrupt parties with rights to possess the premises.

3. **Engage a broker.** Interview and engage a broker with a good reputation and broad knowledge of the market and most importantly, the time and commitment to focus on your deal.
4. **Sweeten the deal.** Is the furniture included in the sublease? If so, will the Subtenant get ownership of the furniture at the beginning or end of the Sublease term (and have the duty to remove it)? Should you cover certain pass-throughs, such as parking charges, fitness center fees, build-out and design costs? These small items may make a huge difference.
5. **Deal with "shared spaces".** If there will be shared spaces, such as bathrooms, reception areas, kitchens, conference rooms, think through the logistics of controlling those spaces and allocating costs.
6. **Evaluate the financial strength of your prospective Subtenants:** Even though a Sublandlord will no longer be occupying the subleased space, it will be liable to the Master Landlord for rent under the Lease, as well as any loss, damage and liability arising from the acts or omissions of the Subtenant. So fully investigate the financial

strength and business reputation of your Subtenants, because you will be acting as their guarantor. You may want to ask for an additional security deposit and periodic financial reports. The Sublease should give you all the rights and remedies available to a landlord, including the right to seek indemnification from the Subtenant for defaults or termination of the Master Lease resulting from the Subtenant's breach.

One of the worst scenarios is when a small Subtenant holds over past the termination date of the Master Lease. In this case, the Master Landlord could claim that the Sublandlord is holding over as to its entire space and is liable for holdover rent for the entire space, not just the portion occupied by the Subtenant. Make sure the Sublease expressly provides that the Subtenant will be liable for the entire holdover rent, not just the holdover rent for its portion of the Master Premises.

### **SUBTENANT CONCERNS**

1. ***Evaluate the financial strength of the Sublandlord.*** If the Sublandlord defaults, you could lose your Sublease. There are several ways to protect yourself:
  - a. Obtain a non-disturbance agreement from the Master Landlord. Most Master Landlords will not agree to provide this to a Subtenant, or if they do, the Subtenant must pay rent at the rate then being paid by the Sublandlord. Nevertheless, if you have any leverage, it is worthwhile pressuring the Sublandlord and Master Landlord for a non-disturbance agreement.
  - b. Make sure the Sublandlord expressly agrees not to default under Master Lease and not to terminate or amend the Master Lease without your consent. The Sublandlord should indemnify you for any losses arise from its breach or wrongful termination of the Master Lease.
  - c. Have both the Sublandlord and Master Landlord agree to provide you written notice of any defaults and that you have the right and opportunity to cure any Sublandlord default. Be sure to get an indemnity/reimbursement agreement from the Sublandlord for any amounts paid to cure its defaults.
2. ***Review the Master Lease carefully.*** Do not expect to be able to renegotiate the Master Lease, so be sure you can live with its terms. If some provisions must be renegotiated, such as the use provision in a retail lease, commence discussions with the Master Landlord early in the subleasing process.
3. ***Negotiate for rights against Master Landlord.*** While most Subleases expressly state that a Subtenant has no direct rights against the Master Landlord, you should try for all or some of the following, particularly if you are taking over all of the Sublandlord's space for all the then remaining term under the Master Lease:
  - a. The right to compel the Sublandlord to enforce its rights against the Master Landlord, including assigning to you all claims against the Master Landlord and/or filing suit at your request. Be aware that the Sublandlord may insist that you cover all costs and indemnify it from all losses arising from any such lawsuit.

- b. The right to compel the Sublandlord to audit operating expenses, again at your cost.
  - c. The right to terminate the Sublease due to the failure of the Master Landlord to provide essential services.
4. **Pass-through expenses.** If the sublease space is not separately metered or billed for utilities and services, craft a fair allocation of those expenses. Or better yet, calculate a gross rent which includes all those expenses so you are not separately billed.
5. **Obtain Consents.** Make sure the Sublease is contingent upon obtain the consent of the Master Landlord (i) to the Sublease itself, (ii) to any modifications of the Master Lease which you are able to negotiate (including the non-disturbance agreement if you have been able to negotiate that), and (iii) to any alterations of the premises to be made by or for you.
6. **Restoration.** Clarify whether any alterations must be removed at the end of your sublease term and by whom. Sometimes a Sublandlord will require the Subtenant to assume all restoration obligations, even those relating to improvements installed prior to the sublease term. Preferably, you would want to remove only those alterations which you installed and only if the Master Landlord and the Sublandlord informed you that you would be required to perform such removal prior to the time the alteration was installed.
7. **Insurance.** Review the insurance provisions of the Master Lease. If you are subleasing only 10,000 square feet of a 100,000 master lease premises, then you may be able to negotiate lower insurance coverage minimums.
8. **Signage and directory listings.** Do not assume that the Master Landlord will provide additional directory listings or signage. Get that in writing before you commit.

### **INCORPORATION BY REFERENCE**

A COMMON MISTAKE IS THE WHOLESALE INCORPORATION OF THE MASTER LEASE. When a provision of the Master Lease is incorporated by reference it means it is restated in your Sublease as written, but substituting Sublandlord for Landlord, Subtenant for Tenant, etc. Your counsel should carefully review the Master Lease to identify what is and is not being incorporated and why.

For instance, the Sublease might casually incorporate by reference the 10% late fee provision from the Master Lease. However, there is no reason why the Sublease cannot have a less harsh late fee, such as a 5%. Do not incorporate deal points which relate solely to the relationship between the Sublandlord and Subtenant, unless you have thought through how they apply.

Certain provisions should not be incorporated, such as a provision which limits the liability of the Master Landlord to its interest in the building. Since the Sublandlord has virtually no interest in the building, the incorporation of such a provision would gut the Subtenant's rights against the Sublandlord. Typically, a Sublease will not incorporate the work letter or the casualty provisions. The Sublandlord is not taking on the construction obligations of the Master Landlord and is not committing to rebuild the premises after a fire.

## **MASTER LANDLORD CONSENT**

Do not be surprised if the Master Landlord will not sign the simple one-line consent at the end of your Sublease. Most sophisticated Master Landlords will employ a three to five page consent which spells out the following:

- That the Master Landlord is consenting to the act of subleasing, not the provisions of the sublease itself.
- That nothing in the Sublease amends the Master Lease or releases the Sublandlord.
- That upon the default of the Master Lease, the Master Landlord may terminate the Sublease or may elect to keep the Sublease in place, all at the option of the Master Landlord.
- That the Sublandlord and Subtenant agree to indemnify the Master Landlord from any brokers commission due as a result of the Sublease.

Last word of advice: Each Sublease transaction is unique, so engage experienced counsel to guide you through the process. In light of the potential risks facing both the Sublandlord and the Subtenant, the cost of legal fees is a small and smart investment.

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*The article above was prepared by Helen Sedwick of Bennett Valley Law.*

*After more than 20 years of practicing law with major firms in San Francisco, Helen Sedwick founded her own firm, Bennett Valley Law in 2007. She continues to specialize in commercial real estate transactions, primarily sales and acquisitions, leasing, entity formation, financing and management. Clients include developers, investors, start up companies, bio-tech companies, solar technology companies, wineries, restaurant franchisees and owners, and individuals. For more information, please visit [www.bennettvalleylaw.com](http://www.bennettvalleylaw.com).*

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