

Take care to avoid sublease headaches

Landlords and tenants alike need to consider some important details before entering discussions

Given the current state of the economy, it should come as no surprise to anyone who follows the commercial real estate market that the amount of sublease space available in Portland has increased – and will likely continue to increase – during the downturn.



LEGAL EASE

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In the past year, from the end of the fourth quarter 2007 to the end of the fourth quarter 2008, the amount of vacant sublease space has increased from 560,000 square feet to more than 740,000 square feet. One can safely assume that this figure has increased substantially over the past three months due to the worsening recession.

Negotiating and documenting subleases is inherently complicated by the fact that there are three interested parties – the building landlord, the original tenant and the proposed subtenant. Consistency of the sublease with the master lease and a clear understanding of the limits on subleasing set out in the original lease, are imperative to a successful sublease transaction, and there are some important issues to consider when entering into subleasing discussions.

The ‘sublease’ vs. ‘assignment’ distinction

Almost universally, a commercial lease will require that a tenant obtain the landlord’s consent prior to entering into any sublease. Because the typical consent provision provides that the tenant may not sublet or assign the lease without consent, it is important to differentiate between these two terms.

Though sometimes used interchangeably as in “the tenant subleased its space to a subtenant” and “the tenant assigned its space to a subtenant,” assignments and subleases are different legal animals, and all sides should be careful to appreciate the difference.

An assignment is the outright transfer of all or part of an existing lease so that the assignee steps into the shoes of the original tenant, assuming all of the rights and obligations of the tenant under the original lease. Sometimes, the original tenant is then released from its obligations under the lease. However, this is rarely seen, because continuing liability without continuing control over the leased premises exposes the original tenant to serious contingent liability for the assignee’s default without any ability to repossess the space from the assignee and remedy or at least mitigate the consequences of an assignee default.

A sublease, on the other hand, involves the creation of a whole separate tenancy between the original tenant and the sub-

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tenant, where the subtenant accepts the rights and responsibilities described in the sublease, and the original tenant has sublease rights and remedies to protect it in respect to its continuing liability on the original lease.

It is important to note that under the law the original tenant will remain liable to the master landlord unless an express release of liability is stated. Silence equals continuing liability on the lease after either an assignment or a sublease.

The ‘consent’ issue: landlord considerations

From a landlord’s perspective, a consent provision that states that landlord’s consent may be withheld in its sole discretion is clearly preferable. This gives the landlord the right to withhold approval without any justification being required and to control the business terms on which its space is subleased.

Many tenants, however, will insist on a reasonableness standard: “Landlord will not unreasonably withhold consent to any assignment or subletting.” A good commercial lease will then list the various factors that a landlord may reasonably consider upon any sublease request. Typical considerations (and conditions) include:

- the financial strength of the subtenant;
- the subtenant’s proposed use;
- whether the original tenant will remain liable on the original lease;
- whether the subtenant will atorn to the landlord upon termination of the original lease; and
- the financial terms of the sublease.

If the original lease does not contain such a list and states only that the landlord must be “reasonable,” a landlord is likely to withhold consent where the proposed sublease would have a negative impact of any significant kind on the landlord or its property.

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The Oregon legal standard is that the landlord must have a bona fide business reason why the consent would adversely affect the landlord's position in order to be justified in withholding the consent. In Oregon, it is unreasonable for the landlord to try and improve on its position as a condition to granting consent.

While one might imagine various unlikely scenarios in which an otherwise innocuous sublease could somehow result in a negative economic impact to the landlord, a landlord should be extremely careful in running this analysis. A landlord who overreaches in this area risks an argument from the original tenant that it has been released from its liability under the original lease due to landlord's interference with its proposed sublease.

Similarly, a landlord should be careful not to overly involve itself in the negotiations of the sublease terms between the tenant and the proposed subtenant and be mindful of any time limits for giving its consent set out in the lease.

The 'consent' issue: tenant considerations

Tenants, on the other hand, should note that a sublease that conflicts with the terms of the original lease is not acceptable. A landlord may withhold its consent to such a conflicting sublease, even if the terms of the deal are otherwise reasonable.

If, for example, a proposed sublease increases the term of the original lease by a year or two – even if the proposed lease calls for terms favorable to the landlord (increase in rent, etc.) – the landlord can arbitrarily withhold its consent and hold the tenant

hostage for better financial terms.

Where a tenant knows that its potential subtenant may require material modifications to the original terms (longer term, different use, etc.), the tenant would be wise to negotiate a modification to the master lease early in the process.

An ounce of preparation ...

Again, the best solution to all of these issues is for the original lease to clearly enumerate the considerations that the landlord may take into account in evaluating a potential sublease. Failing that, landlords and tenants can avoid most issues by negotiating the form of landlord's consent early in the sublease process (perhaps even prior to the tenant listing the space as available for sublease). If the original tenant and the subtenant are clear on what will be required in order to obtain landlord's consent, everyone can avoid the surprises that sometimes lead to abandoning good deals.

There is interesting interplay between the landlord's legal duty in Oregon to mitigate its damages by reletting the premises when the tenant abandons the premises and the landlord's right to withhold consent in its sole discretion to an assignment or sublease.

Subleasing and assignment is an inherently complex discussion with many issues, and one should strongly consider consulting a competent real estate lawyer to avoid potential headaches down the road.

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