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## **Sublease Negotiation Tips**

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## SUBLEASE NEGOTIATION TIPS

(Bernard O. Dow Leasing Institute)

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### I. INTRODUCTION

In Houston, Texas, at the end of calendar year 2016, there was over 11.1 million square feet of available sublease space. This was more than five times the amount of sublease space available in Dallas, Texas and the equivalent of the amount of sublease space available in Boston, Manhattan, and Washington, D.C., combined.<sup>1</sup> While the supply of local sublease office space has started to shrink, Houston by far has the most sublease space of any market in the nation, according to CBRE.<sup>2</sup> As real estate attorneys practicing in the Houston market, it is important to understand the issues and pitfalls in negotiating and drafting subleases and be able to effectively convey these issues and concerns to our clients and negotiate sublease documents which operate successfully for the prime landlord, sublandlord, and subtenant.

In the current leasing market, potential tenants are more willing to sublease space than to assume a tenant's interest in an existing lease, and existing tenants are more willing to sublease space than to assign the lease to a new tenant. This is because the liability of the parties following a sublease versus an assignment is different. Following an assignment, although the original tenant will remain liable unless the prime landlord releases the original tenant from liability, the original tenant has little control over whether the assignee performs under the prime lease and the original tenant has no means to perform such obligations in the event that the assignee does not perform. In a sublease structure, a subtenant may be able to lease less than the entirety of the prime leased premises under the prime lease, for a fraction of the rental rate under the prime lease, or for a shorter term than the prime lease, but the original tenant retains control to perform under the prime lease if the subtenant does not. Note that an assignment transfers ALL of a tenant's rights and interests in the prime lease, while a sublease transfers LESS rights than in the prime lease and the sublandlord retains a reversionary interest in the subleased premises.

### II. COMMON MISCONCEPTION AND SUBLEASE FORMATS

The most common misconception is that drafting a sublease is "easy" or "simple" – a short, one-page document to which the prime lease is attached. This is not the case. Sublease documentation is more involved and complex than the documentation for a standard lease because there are multiple parties, multiple documents, and complex issues. To make matters worse, there is often pressure from either the client or a broker, or both, to quickly create a simple and inexpensive sublease document. A sublease structure has three parties: prime landlord, original tenant/sublandlord, and subtenant, and at least two documents: prime lease and sublease.

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<sup>1</sup> Houston Chronicle, *Houston Leads The Nation In Sublease Office Space*, February 27, 2017.

<sup>2</sup> Houston Chronicle, *Houston Leads The Nation In Sublease Office Space*, February 27, 2017.

The sublease instrument can take different forms:

- A. Prime Lease as a Template. The prime lease can be used as a template, wherein the entire prime lease is repeated in a sublease form. This results in an unnecessarily lengthy sublease document.
- B. New Lease. An entirely new lease can be drafted, so long as special care is taken that none of the provisions go outside of the boundaries of the prime lease. Again, this results in an unnecessarily lengthy sublease document.
- C. Incorporate the Prime Lease by Reference. This is the most typical sublease format. This document structure incorporates the entire prime lease by reference with a statement that all references to "Landlord" shall refer to the sublandlord, all references to "Tenant" shall refer to the subtenant, all references to "Premises" shall refer to the subleased premises, etc.; however, this structure requires careful consideration of what rights and obligations under the prime lease need to be excluded or revised for the sublease parties.

Provisions of the prime lease that are usually excluded from being incorporated into the sublease and/or specifically tailored for the sublease are: (i) rights to assign or sublease, (ii) exculpation provisions (if you represent the subtenant), (iii) sublandlord's right to self-insure, if any, (iv) rent, (v) tenant allowances, (vi) rights of first refusal, or any other preferential rights, (vii) insurance obligations of the prime landlord, (viii) representations and warranties, (ix) representations and indemnification regarding brokers, (x) parking rights, (xi) requirements to deliver an SNDA from the mortgagee, (xii) signage rights, and (xiii) prime landlord's obligation to maintain the common areas. The practitioner will need to review the prime lease in its entirety to determine whether other provisions exist that would be inappropriate to incorporate into the sublease.

### III. GENERAL ISSUES

- A. Structure of the Transaction. The prime lease sets the limits of the sublease, and the sublease is always subject to and subordinate to the prime lease. If the prime lease terminates for any reason, the sublease will terminate. It is critical to the subtenant that the sublandlord timely perform under the prime lease and, if not, that the subtenant obtains rights and time to perform the sublandlord's obligations on behalf of the sublandlord.
- B. Prime Lease Limitations on Subleasing. Most leases will contain provisions regarding conditions to subleasing or limitations on the existing tenant's right to sublease the prime leased premises. These provisions should be reviewed carefully as they could affect the business terms between the sublandlord and subtenant. For example, the prime lease may require that the rental rate payable under a sublease is not less than the rental rate paid by the tenant under the prime lease. In most cases, prime landlord's consent will be required for the tenant to sublease all or a portion of the prime leased premises.

- C. Privity of Contract and Relationship of Parties. In a sublease structure, there is no privity of contract between the prime landlord and the subtenant. The subtenant has rights only vis-à-vis the sublandlord. Therefore, the subtenant's only right if the prime landlord fails to perform its obligations under the prime lease is to require that the sublandlord enforce its rights against prime landlord under the prime lease. Each party can only be responsible for what it is practically able to do. For example: although the sublease may incorporate the provisions of the prime lease which require the prime landlord to maintain the common areas of the building, the sublandlord cannot maintain the common areas because it does not have the right, as a tenant in the building; the subtenant cannot maintain portions of the prime leased premises which are outside of the subleased premises (in the event the subleased premises is less than the entire prime leased premises); sublease rent is payable to the sublandlord, but the subtenant cannot ensure that the sublandlord passes such rent to the prime landlord or that the sublandlord pays the rent for the remainder of the prime leased premises (in the event the subleased premises is less than the entire prime leased premises); and the subtenant may be obligated by incorporation of the prime lease to remove all improvements in the subleased premises, but the subtenant may not want the obligation to apply to those improvements which existed prior to the commencement date of the sublease.
- D. Modifications to the Prime Lease. If the prime lease is incorporated by reference, any subsequent modifications to the prime lease will apply to the sublease. Thus, the subtenant will want to retain control over sublandlord's ability to amend the terms of the sublease; however, if the sublease covers only a portion of the prime leased premises or a portion of the term of the prime lease, sublandlord will want to retain the right to modify the prime lease without consent of the subtenant. As a compromise, the parties can agree that sublandlord will not modify the terms of the prime lease without the subtenant's consent, to the extent such amendment would (i) adversely affect the subtenant's rights under the sublease, (ii) increase the obligations of subtenant under the sublease, or (iii) decrease the size of the subleased premises, shorten the term of the sublease, or otherwise materially affect the subleased premises. In addition, sublandlord should be able to amend the provisions of the prime lease excluded from the sublease as they are not applicable to the sublease.

#### **IV. SOLUTIONS FOR GENERAL ISSUES**

For obligations that the sublandlord cannot perform due to the nature of the obligations (for example: structural alterations, maintenance of common areas, or restoration of the subleased premises following a casualty), the sublandlord should not assume liability for non-performance unless the non-performance is caused by a default by the sublandlord. Below are some solutions that the subtenant can negotiate in order to mitigate risks resulting from the fact that the subtenant does not have privity of contract with, or enforcement rights against, the prime landlord.

- A. Sublandlord as the Enforcer. The sublease should require that the sublandlord take all reasonable action to enforce its rights against the prime landlord under the prime lease for

non-performance by the prime landlord. This may include sending written notice to the prime landlord, enforcing rent abatement rights under the prime lease, filing suit against the prime landlord, or enforcing sublandlord's self-help rights (if any) under the prime lease. Taking such action will usually be at the sole cost and expense of the subtenant. If enforcing the obligations of the prime landlord would benefit portions of the prime leased premises not part of the subleased premises, then the costs of enforcement should be allocated between the subtenant and sublandlord accordingly.

- B. Assignment of Rights. The sublease may provide that the sublandlord partially assigns its enforcement rights to the subtenant in the event that the prime landlord continues to fail to perform its obligations under the prime lease, which assignment should include the right to proceed against the prime landlord in the subtenant's own name. The partial assignment also should expressly state that all rights of sublandlord under the prime lease are conferred upon and transferred to subtenant. Subtenant shall be subrogated to any rights of the sublandlord as such rights apply to the subleased premises. Note that, per the prime lease, sublandlord may not be permitted to assign or partially assign such rights to the subtenant, in which event subtenant may require that sublandlord permit subtenant to proceed against prime landlord in sublandlord's name.
- C. Self-Help. To the extent that the prime lease permits the tenant under the prime lease to exercise self-help remedies (i.e., perform the obligations of the prime landlord), sublandlord should agree to exercise such rights for the benefit of the subtenant. Note that the sublandlord may not be able to exercise these rights or may not want to provide this right to the subtenant if the subleased premises is only a portion of the prime leased premises.
- D. Pass-Through of Rights and Remedies. The parties should negotiate whether sublandlord's right to abatement, credits, set-off, or offset under the prime lease should pass through to the subtenant, to the extent related to the subleased premises. Be wary of one potential issue with simply passing through to the sublease abatement and similar rights under the prime lease; circumstances may arise where subtenant's right to abatement is triggered, but sublandlord's right to abatement is not. This can result if the trigger for such right is tied to a threshold. For example, if abatement is granted if a material portion of the "premises" is untenable, a "material portion" of the subleased premises may not be equivalent to a "material portion" of the prime leased premises. Therefore, an incorporation into the sublease without any limitation may provide the subtenant with an abatement right against the sublandlord which is not available to the sublandlord under the prime lease.
- E. Recognition Agreement. If the subtenant cannot obtain the right to proceed against the prime landlord because the prime lease does not permit assignment of enforcement rights to the subtenant, subtenant should request a recognition agreement from the prime landlord. A recognition agreement is similar to a subordination, non-disturbance and attornment agreement between a tenant and a lender. In a recognition agreement, the

prime landlord (i) consents to the sublease by subtenant of the subleased premises, (ii) agrees to perform its obligations under the prime lease, and (iii) agrees to the enforcement of those obligations by the subtenant. A recognition agreement provides subtenant with privity of contract with the prime landlord. Unfortunately, many prime landlords are unwilling to enter into recognition agreements because it expands the scope of liability of the prime landlord and may increase prime landlord's obligations.

**V. OTHER GENERAL FACTORS TO CONSIDER**

- A. Entire Premises v. Partial Premises. When the subtenant subleases the entire prime leased premises, obligations are more cleanly passed through to the subtenant because there is no remainder premises for which the sublandlord remains responsible. When the subleased premises is less than the entire prime leased premises, more careful consideration should be made as to what obligations and rights pass through to the subtenant. For example, if the prime leased premises is an entire floor of a building, the prime lease likely does not discuss access rights to elevators, stairwells, and common area restrooms, but if the subleased premises is only a portion of such floor, such floor becomes a "multi-tenant" floor and respective rights will need to be addressed in the sublease document. The same attention should be paid to maintenance and repair obligations between the sublandlord and subtenant which would not be necessary under the prime lease between the prime landlord and tenant.
- B. Length of Term. If the parties intend that the sublease cover the entire remainder of the term of the prime lease, the parties may want to stipulate the term of the sublease to be one day shorter than the remainder of the term of the prime lease to mitigate the risk that the sublease be deemed by a court to be an assignment of the prime lease.
- C. Rent Amount. Rent under the sublease may be less, more or the equivalent of the rent under the prime lease. Remember to review the prime lease for any limitations or stipulations on the rent payable under a sublease. Some prime leases may require that the tenant pay the prime landlord all or a portion of any rent received from a subtenant that is in excess of the rent payable under the prime lease.
- D. Computation of Time Periods. It is critical that the time periods in the sublease be recomputed and that the parties do not simply just rely on time periods referenced in the prime lease. If an event requires action of the prime landlord or action by the sublandlord to the prime landlord, then the time periods under the sublease need to be shorter or longer to accommodate the additional step of working through the sublandlord. For example, if prime landlord's consent is required and prime landlord has 15 days to provide its consent, if the sublease provides that the sublandlord has the same 15 days to provide consent, then there would not be sufficient time for the sublandlord to act as the middle man and deliver a consent request to the prime landlord. Therefore, the sublease should provide that sublandlord has more time (for example, 25 days) to provide its consent to subtenant in order to allow time for the sublandlord to notify the prime landlord, obtain a response from the prime landlord, and then notify the subtenant of both prime landlord's

and sublandlord's consent. The reverse also applies. For example, if the sublandlord, as tenant under the prime lease, has 30 days to complete repairs, the sublease should require that the subtenant perform such repairs within 20 days so that, in the event subtenant does not complete the repairs, sublandlord still has 10 days to complete the repairs before sublandlord, as tenant under the prime lease, would be in default under the prime lease.

Addressing the issues with time limits can be handled by specifically stating different time limits for specific circumstances and then a "catch-all" provision covering the duration of time limits not specifically addressed in the sublease:

"Time Limits for Performance. Except for instances where a time limit for performance is specifically set forth in this Sublease: (x) if the Primary Lease provides for a time limit for Sublessor's performance (as the tenant under the Primary Lease), then the time limit under this Sublease for the corresponding Sublessee performance shall be the greater of (i) three (3) days less than the time limit stated in the Primary Lease or (ii) two (2) days; or (y) if the Primary Lease provides for a time limit for Landlord's performance, then the time limit under this Sublease for the corresponding Sublessor performance shall be three (3) days longer than the time limit stated in the Primary Lease."

## **VI. ISSUES TO REVIEW BEFORE AGREEING TO SUBLEASE**

- A. Prime Landlord Consent Rights. The prime lease may require the prime landlord's consent to sublease all or any portion of the prime leased premises to a third party. Therefore, the tenant/sublandlord should discuss with the prime landlord the possibility of subleasing the prime leased premises and whether the prime landlord would be amenable to consenting to the sublease. Many prime leases contain provisions that require that the consent request include a copy of the sublease document. Therefore, the sublandlord and subtenant will need to negotiate and, sometimes, execute the sublease prior to obtaining the prime landlord's consent. In this case, it is more important for the sublandlord to discuss the sublease with the prime landlord prior to taking the time and incurring the expense of negotiating a sublease agreement. In such case, the sublease document should contain a provision that either (a) the effectiveness of the sublease is conditioned upon obtaining the consent of the prime landlord or (b) that either party may terminate, as its sole remedy, in the event that the prime landlord's consent is not obtained by a date certain.
- B. Prime Landlord Recapture Rights. The prime lease may provide that the prime landlord has the right to terminate the prime lease as to the subleased premises and "recapture" such space in the event the tenant under the prime lease requests prime landlord's consent to a sublease. The recapture right may permit prime landlord to terminate the entire prime lease in the event that only a portion of the prime leased premises is to be subleased. Be sure to review the exact language of the prime lease regarding the prime landlord's recapture right, as prime landlord's right may be triggered by any type request to sublease



(written or oral; as to the entire prime leased premises or merely the proposed subleased premises).

- C. Prime Lease is Silent Regarding Subleasing. In most states, if a lease is silent regarding the right of the tenant to assign the lease or sublease the leased premises, the lease is freely assignable. Texas, however, is unique. In Texas, if the lease is silent regarding the right of the tenant to assign the lease or sublease the leased premises, assignment and/or subleasing is prohibited without landlord's consent. Further, in Texas, absent language in the lease to the contrary, there is no requirement that the landlord act reasonably in its decision on whether to consent.

## **VII. RENEWAL RIGHTS**

Any renewal rights granted to the subtenant under the sublease agreement are subject to the renewal right of the sublandlord under the prime lease. Note that under some prime leases, the renewal option cannot be exercised if all or a portion of the prime leased premises has been subleased. It is critical to the subtenant that the sublandlord be required to exercise its renewal option under the prime lease if the subtenant exercises its right to renew the term of the sublease. In drafting the sublease, it is important to keep in mind timing of exercise of renewal rights and rental rates upon renewal:

- A. Timing. The sublandlord should allow sufficient time to exercise its renewal option under the prime lease after receiving notice from the subtenant of subtenant's exercise of the renewal option under the sublease. Therefore, the time for providing notice of subtenant's exercise of the renewal option needs to be earlier than the date for notice required in the prime lease. The more likely scenario, however, is that the rent payable under the sublease and the prime lease will be due on the same day, which means that the sublandlord will be required to pay the prime landlord rent under the prime lease before it receives the rent from the subtenant.
- B. Rental Rates. The parties should review the prime lease to determine whether the rental rate will change or increase during any renewal terms. If so, the sublandlord will want to pass such increase through to the subtenant. If the rental rate for the renewal term under the prime lease is to be the "fair market" rental rate, the subtenant will want to be involved in the process for determining the fair market rent because, most likely, such rent amount will be passed through to the subtenant. If the tenant under the prime lease has the right to revoke its exercise of the renewal option if the parties cannot agree on the fair market rental rate, then the sublease should provide that the sublandlord will not revoke its exercise of the renewal option if the subtenant does not intend to revoke its exercise of the renewal option under the sublease or if the subtenant agrees to pay the rental rate determined by the prime landlord (even though the sublandlord may not agree with the amount determined). The sublease should clearly set forth the role that the subtenant will play in the decision regarding rental rate under the prime lease, how such rental rate affects the rent under the sublease, and what rights the subtenant has to revoke the exercise of its renewal option. Subtenant's rights regarding the fair market rental

determination process may be included in any recognition agreement obtained from the prime landlord.

## **VIII. RENT ISSUES**

- A. General Issues. As discussed above, some prime leases may require that the tenant pay the prime landlord all or a portion of any rent received from a subtenant which is in excess of the rent payable under the prime lease. Because the sublandlord will want to have received the rent due from the subtenant under the sublease prior to paying the rent under the prime lease, the sublease should provide that the sublease rent is due on a date earlier than the date the rent under the prime lease is due. The more likely scenario, however, is that the rent payable under the sublease and the prime lease will be due on the same day, which means that the sublandlord will be required to pay the prime landlord rent under the prime lease before it receives the rent from the subtenant.
- B. Common Area Maintenance Costs. The subtenant should be required to pay its prorata share of the common area maintenance costs. In a multi-tenant property, the prime landlord (and not the sublandlord) is in control of the common area maintenance, repairs, expenses, etc. Thus, certain provisions in the prime lease related to the common area expenses cannot be incorporated into the sublease because the sublandlord is not able to perform the obligations that the prime landlord is required to perform. For example, passing through rights to audit prime landlord's books related to the common area maintenance costs; the sublandlord does not have control over the books to provide the subtenant with the audit right and sublandlord may not have the right to pass the audit rights to the subtenant via confidentiality provisions. To address this disconnect, the sublease should provide that (i) to the extent permitted under the prime lease, the sublandlord will assign its audit rights to the subtenant and (ii) if the audit rights are not assignable, then the sublandlord will perform an audit on behalf and at the sole cost of the subtenant. In a single-tenant lease situation in which the tenant is responsible for all maintenance related to the building, the prime lease will likely not include common area maintenance language; however, if the subleased premises is less than the entire prime leased premises, the sublandlord may act as "landlord" in performing common area maintenance, in which case the sublease agreement will need to add standard common area maintenance provisions regarding payment by the subtenant of a prorata share of such costs.
- C. Percentage Rent. Percentage rent provisions (which typically are only in retail leases) can be tricky if the subtenant is subleasing only a portion of the prime leased premises. Consider how the determination of gross sales and break-even analysis will work when the sales under the prime lease are based on two or more separate businesses (the business of the subtenant within the subleased premises and the business of the tenant in the remainder of the prime leased premises). If the prime lease requires percentage rent, the subtenant and sublandlord need to carefully construct the percentage rent terms under the sublease in a manner that can still work under the provisions of the prime lease. In

addition, the sublease will need to require the subtenant to provide financial information to the prime landlord upon request or as required by the tenant under the prime lease.

- D. Security Deposit. The obligation of the tenant under the prime lease to provide a security deposit to the prime landlord should not be passed through to the subtenant. The sublandlord should evaluate the subtenant's financial strength to separately determine whether the sublandlord needs to require a security deposit from the subtenant. If the subleased premises is less than the prime leased premises, the security deposit required to be paid by the subtenant will likely be less than the security deposit paid by the sublandlord as tenant under the prime lease. Sublandlords should be careful if requiring a security deposit that is less than the security deposit paid by it under the prime lease because if the subtenant defaults under the sublease (and causes the sublandlord to default under the prime lease), the sublandlord's loss of its security deposit may not be covered by the security deposit obtained from the subtenant.

## **IX. DEFAULT**

- A. By Subtenant. The default by the subtenant under the sublease may cause a default by the sublandlord under the prime lease. An issue arises when the subleased premises is less than the entire prime leased premises, because a default by such subtenant may place the entire prime lease into default and subject the sublandlord to all of the remedies available to the prime landlord under the prime lease. The parties need to consider the relative liability and limitations on liability of the parties as related to the potential damage which may be incurred by the non-defaulting party.
- B. By Sublandlord. Defaults by sublandlord will be primarily focused on (i) sublandlord's failure to enforce the prime landlord's obligations under the prime lease; and (ii) sublandlord's default under the prime lease. The main concern of the subtenant is that if the sublandlord defaults under the prime lease, even if such default is unrelated to the subleased premises, the sublease could be terminated through no fault of the subtenant. Consider:
1. Remedies against the sublandlord to include consequential damages if the sublease is terminated due to sublandlord's default under the prime lease, which is not caused by the subtenant's default under the sublease; and
  2. A recognition or other agreement between the prime landlord and subtenant which provides notice and opportunity to cure for subtenant to cure sublandlord's defaults and the right of the subtenant to enter into a direct lease with the prime landlord if the prime lease is terminated.
- C. By Prime Landlord. As discussed above, the subtenant has no direct recourse against the prime landlord. Rather, the subtenant should obtain the express obligation of the sublandlord to enforce its rights under the prime lease against the prime landlord or the assignment by sublandlord of such rights to subtenant (if so assignable) and, if possible, a

recognition agreement with the prime landlord which grants subtenant the direct right to enforce the prime lease against the prime landlord.

- D. Notice and Cure Periods. Because the failure of a subtenant to perform under the sublease would cause the tenant to default under the prime lease, the notice and cure periods under the sublease should be shorter than the periods under the prime lease in order to provide sublandlord the time and opportunity to cure the default in the event that the subtenant has not cured the same by the expiration of the subtenant's cure period.

**X. LIABILITY CONCERNS**

- A. Indemnity Obligations. The sublandlord will want to make sure that the subtenant's indemnity obligation covers both the sublandlord and the prime landlord to the extent of sublandlord's indemnity obligations under the prime lease. Any indemnification by prime landlord of tenant under the prime lease should not be extended by incorporation of the prime lease by reference to be an indemnification by sublandlord of subtenant under the sublease because the sublandlord may not have any responsibility for, control over, or insurance coverage for, the matters for which prime landlord is indemnifying sublandlord (for example, claims arising in connection with the common areas, which, for sublandlord, would be an uninsured risk). Any indemnity by sublandlord should be narrowly drafted to cover only sublandlord's obligations under the sublease and not prime landlord's obligations under the prime lease. The subtenant should request certain exclusions from its indemnification of sublandlord and prime landlord: (1) liability of the sublandlord existing prior to the effective date of the sublease; (2) obligations arising from the portion of the prime leased premises which is not the subleased premises; and (3) environmental or other conditions which exist prior to the effective date of the sublease.
- B. Insurance Obligations. Sublandlord will want to require the subtenant to maintain at least the same insurance required to be maintained by sublandlord, as tenant, under the prime lease, but limited to the subleased premises; however, if the subleased premises is only a portion of the prime leased premises, maintaining the same insurance coverage amounts required under the prime lease may be overkill and too costly for the subtenant, relative to the size of the subleased premises. Such amount of coverage may not be market for the size of the subleased premises. The parties should carefully review the allocation of insurance for alterations and tenant improvements, as those relate to the subleased premises versus the remainder of the prime leased premises.
- C. Waiver of Subrogation. The parties can pass-through the waiver of subrogation from the prime lease to the sublease; however, it is better to have separate waivers of subrogation and releases in the sublease agreement in order to more clearly identify the parties and each of their respective waivers, releases and obligations. Note that the prime landlord's waiver of subrogation will not benefit the subtenant and the subtenant's waiver of subrogation will not benefit the prime landlord, unless expressly stated. Therefore, the prime landlord's insurer could pursue subrogated rights against the subtenant (and vice

versa). The subtenant and prime landlord should request specific waiver of subrogation in the prime landlord's consent instrument or in a recognition agreement.

- D. Limitation of Liability/Exculpation. In many prime leases, the prime landlord's liability is limited to its interest in the leased premises or in the building in which the leased premises is located. When representing a subtenant, such provision should not be passed-through to the sublease because the sublandlord's interest in the subleased premises or in the building is only its leasehold interest pursuant to the prime lease; an interest with no value once the prime lease terminates. Thus, if the prime lease is terminated, the sublandlord's interest is nothing, and the subtenant could find itself in the position of having no viable recourse against the sublandlord. If the sublandlord insists on a limitation of liability, consider an amount certain.

## **XI. MAINTENANCE AND REPAIR OBLIGATIONS; ALTERATIONS**

Different considerations are required depending on whether the building is a multi-tenant or single-tenant building and whether the subleased premises is a portion of the entire prime leased premises. Keep in mind when referencing the prime lease that some of prime landlord's obligations under the prime lease cannot be completed by the sublandlord (such as common area maintenance or structural repairs and capital improvements) and some obligations of the tenant under the prime lease should not become obligations of the subtenant (such as maintaining any portion of the prime leased premises that is not within the subleased premises).

- A. Single-Tenant/Entire Prime Leased Premises Subleased. In a single-tenant building, the prime lease will likely require that the tenant maintain and repair all non-structural portions of the building, and possibly some structural, mechanical, electrical, plumbing, and HVAC systems. These obligations of the tenant under the prime lease can be passed-through in their entirety to the subtenant. The sublandlord may not be able to assume all of the obligations of the prime landlord (such as structural repairs), and those obligations should be excluded from the pass-through provisions.
- B. Multi-Tenant/Entire Prime Leased Premises Subleased. Under the prime lease, the prime landlord and tenant will likely divide certain maintenance and repair obligations, depending on the extent that the maintenance or repairs would benefit the tenant exclusively (e.g., the prime leased premises) or all tenants of the building (e.g., the common areas). The obligations of the tenant under the prime lease should be passed-through to the subtenant, but the obligations of the prime landlord should not pass through as obligations of the sublandlord. Sublandlord can only agree to use commercially reasonable efforts to notify the prime landlord of the need of repairs and maintenance and to enforce its rights against the prime landlord under the prime lease. Note that if the prime landlord enters into a recognition agreement, subtenant should obtain the prime landlord's agreement to maintain and repair the building and common areas in accordance with the prime lease.
- C. Partial Prime Leased Premises Subleased (Single and Multi-Tenant). The concerns regarding sublandlord's capability to perform the prime landlord's repair and maintenance obligations

in a pass-through situation discussed in paragraphs A and B above also apply to the sublease of less than the entirety of the prime leased premises. The subtenant will assume the tenant's maintenance and repair obligations, but only as they relate to the subleased premises. Subtenant should not assume obligations related to the remainder of the prime leased premises. The sublease agreement needs to clearly identify that the sublandlord will maintain and repair the remainder of the prime leased premises because failure to maintain the remainder of such space could affect the use of the subleased premises and would be a default by the sublandlord under the prime lease.

- D. Alterations. The prime lease likely will require prime landlord's consent for certain alterations to the prime leased premises. The subtenant should try to negotiate that if the prime landlord consents to alterations to the subleased premises, the sublandlord will be deemed to have consented. This will prevent the subtenant from needing consent from two different parties. The counter should be true as well – if the prime landlord denies consent, sublandlord should be deemed to have denied its consent.

## **XII. HOLDOVER AND SURRENDER**

Sublandlord should be wary of the possibility that a holdover by the subtenant as to the subleased premises would cause a holdover by the sublandlord of the entire prime leased premises. Therefore, the sublandlord will want to negotiate that the subtenant's liability for holding over in the subleased premises includes all of the holdover liability of sublandlord under the prime lease. In addition, the sublandlord should provide itself with a margin of safety in the event that the subtenant holds over (e.g., if the holdover rent under the prime lease is 150%, the sublease holdover rent could be 200%) in order to cover additional costs related to subtenant's holdover, such as defense costs. If the sublandlord requires this margin of safety, the subtenant may be able to negotiate to pay the greater of (i) the higher holdover rent, or (ii) the holdover rent payable under the prime lease; however, subtenants need to be careful with this concept in cases where the subleased premises is less than the entire prime leased premises. Consideration regarding timing needs to be taken into account, such that the subtenant is required to vacate the prime leased premises prior to the date that the tenant is required to vacate the prime leased premises under the prime lease. This will allow the sublandlord time to prepare the subleased premises in the required surrender condition if the subtenant does not do so. Note that permitting a surrender under the sublease (or having the term of the sublease expire prior to the term of the prime lease) may result in a breach of any continuous operation covenants under the prime lease. The subtenant should be concerned with obligations to remove tenant improvements that pre-existed the sublease, since this could be a costly endeavor for the subtenant.

## **XIII. CASUALTY AND CONDEMNATION**

- A. Termination Rights. The sublandlord's right to terminate the prime lease due to casualty or condemnation should be passed-through to the subtenant (as it relates to the termination of the sublease); however, the provisions in the prime lease should be reviewed carefully to avoid a situation where the subleased premises is too small a portion of the prime leased premises to trigger the termination right under the prime lease even if all of the subleased

premises is damaged by the casualty or taken in a condemnation. Thus, the subtenant may have the right to terminate the sublease but the sublandlord does not have the right to terminate the prime lease. If the termination rights in the sublease are revised to reflect the square footage required to terminate under the prime lease, then the subtenant may not have the right to terminate the sublease even if all of the subleased premises are damaged or taken. The opposite is true as well – the prime landlord's right to terminate may be triggered under the prime lease for substantial damage to the prime leased premises even if there is little or no damage to the subleased premises.

- B. Rent Abatement. Any rent abatement provided to the tenant under the prime lease may be passed-through to the subtenant depending on the negotiating power of the subtenant. If such right is passed-through to the subtenant without the qualifier discussed below, a situation may arise where the subtenant is entitled to rent abatement under the sublease but the sublandlord is not entitled to rent abatement under the prime lease (e.g. if a substantial portion of the subleased premises is damaged by a casualty but only a minor portion of the prime leased premises is damaged, and rent abatement under the prime lease is based on a threshold of area damaged). The sublandlord should qualify the pass-through of rent abatement so that the subtenant receives an abatement only to the extent that sublandlord actually receives rent abatement under the prime lease; however, the subtenant will likely negotiate for the right to rent abatement regardless of whether sublandlord actually receives abatement under the prime lease.
- C. Obligation to Rebuild. The obligation of restoring the subleased premises following a casualty or condemnation should be similar to the obligation of restoration under the prime lease, but remember that because sublandlord most likely does not have the right or obligation under the prime lease to restore the prime leased premises following a casualty or condemnation, it can only be tasked with the obligation to be the "enforcer" of such obligations of the prime landlord. Be sure to limit the obligation to restore the subleased premises to only instances where the prime landlord's restoration obligations are triggered under the prime lease.

#### **XIV. OTHER CONCERNS**

- A. Permitted Use. Subtenant's permitted use must coordinate and be permitted under the prime lease.
- B. Continuous Operations Obligations. Continuous operations covenants should be carried over to the sublease. If not, the sublandlord could find itself in a difficult situation if the subtenant vacates the subleased premises but continues to pay rent, in which event the subtenant would still have the exclusive right to occupy the subleased premises pursuant to the sublease but sublandlord would be in default of the covenant of continuous operations under the prime lease without any recourse against the subtenant or the ability to cure the default.

- C. Signage Rights. If the sublandlord leases a significant portion of a building or shopping center, it may have signage rights under the prime lease that it may not be willing to provide to a subtenant leasing a portion of the prime leased premises. In addition, some prime leases do not permit subtenants (even those subleasing the entire prime leased premises) to have signage rights. Thus, the parties need to carefully consider whether signage rights can be or should be passed through to the subtenant. If the signage rights can be passed through to the subtenant and the prime leased premises is divided between sublandlord and subtenant, then the sublandlord may need to request additional signage rights from the prime landlord in order to have identifying signage for both the subleased premises and the remainder of the prime leased premises. The parties will need to work with the prime landlord in these negotiations.
- D. Leasehold Financing; Subordination Agreements. Even though the sublease may state that either sublandlord's lien is subordinate to subtenant's purchase money financing or that sublandlord waives its lien rights, the parties should review the prime lease to determine what lien rights the prime landlord has. If the prime landlord has lien rights that are not automatically subordinate to the subtenant's financing or otherwise waived, the subtenant will need to request a subordination or waiver from the prime landlord.

**XV. PRIME LANDLORD CONSENTS, RECOGNITION AGREEMENTS AND OTHER PRIME LANDLORD CONCERNS**

- A. Consents. Prior to execution of a consent to sublease, the prime landlord should review the sublease agreement and any information regarding the subtenant (including financial information). For clarity purposes, the copy of the final and complete sublease agreement should be attached to the consent. The prime landlord should try to obtain the representations stated below under paragraph C. Note that a consent to sublease does not create privity of contract between prime landlord and subtenant and should not increase any liability or obligations of prime landlord under the prime lease.
- B. Recognition Agreements. A recognition agreement is a direct agreement between the prime landlord and the subtenant where the prime landlord agrees to recognize the subtenant's right to occupy the subleased premises and the prime landlord agrees not to extinguish such right in the event of the termination of the prime lease so long as the subtenant agrees to be bound by the terms of the prime lease. Provisions similar to a subordination, non-disturbance and attornment agreement are contained in recognition agreements, such as: prime landlord is not liable for acts or omissions of sublandlord, prime landlord is not bound by any amount of sub-rent paid more than one month in advance, and prime landlord is not bound by any amendments made to the sublease without prime landlord's written consent. The recognition agreement should contain provisions allowing the subtenant to enforce certain obligations of the prime landlord (such as repair and maintenance obligations and restoration obligations) and provisions regarding subtenant's rights in the event that the sublandlord defaults under the prime lease. The recognition agreement can also provide that in the event prime landlord intends to sell the



building in which the prime leased premises is located, the subtenant will cooperate in providing estoppels and any due diligence items.

C. Primary Concerns of the Prime Landlord.

1. Sublandlord and subtenant should represent to the prime landlord that the sublease agreement provided to prime landlord for review is the final and complete copy of the sublease agreement.

2. The amount of rent payable under the sublease should be confirmed in the event that the prime landlord is entitled to a portion of the rents paid to sublandlord in excess of the rent paid under the prime lease.

3. Subtenant should represent that the financial information provided to the prime landlord is accurate because, in many cases, the prime landlord is relying on the financial strength of the subtenant in determining whether to consent to the sublease. Subtenant should agree to provide additional financial information upon request by prime landlord.

4. Prime landlord should try to obtain estoppel-like representations from the sublandlord and subtenant, confirming that the prime landlord is in compliance with the terms of the prime lease, and there are no defenses or offset rights to sublandlord's obligations under the prime lease, as the tenant thereunder.

5. Prime landlord should obtain confirmation from the sublandlord and subtenant of the legal relationship among the parties and documents: (a) the sublease is subject to and subordinate to the prime lease; (b) a violation under the sublease is a violation under the prime lease; (c) the prime lease and the relationship between prime landlord and sublandlord are not altered by the sublease; (d) prime landlord is not bound by the terms of the sublease; (e) subtenant does not have the right to enforce any terms of the sublease against the prime landlord; and (f) sublandlord, as tenant under the prime lease, is not released from any obligations under the prime lease. Note that these matters may be negotiated in a recognition agreement.

6. Prime landlord will want to negotiate certain covenants into a recognition agreement or consent if these are not already included in the sublease: (a) subtenant cannot further sublease the subleased premises or assign the sublease; (b) sublease may not be amended without the consent of the prime landlord; (d) any notices of default in connection with the sublease shall be delivered to prime landlord; (e) subtenant will provide an estoppel certificate upon request of prime landlord; (f) indemnification from subtenant; and (g) waiver of claims by the subtenant and agreement by the subtenant as to certain insurance requirements (such as naming prime landlord as an additional insured).

## **XVI. LENDER CONCERNS**

Keep in mind that the prime landlord's lender's consent may be required for the sublease. Whether a lender's consent is required will be dependent on lender's lease approval rights in the loan documents. Note that although a sublease of the subleased premises may be considered a minor lease under the loan documents that does not require lender's consent, if the subleased premises is a portion of the prime leased premises of a major lease, lender's consent may still be required. A lender will need to consider whether having unoccupied space in its collateral is better (or worse) than having sublease structure. In such consideration, the lender will need to consider the financial viability of the subtenant. A subtenant that subleases a substantial amount of space will likely want an SNDA from the lender. Although the lender has no obligation to provide an SNDA, most lenders will be reasonable with respect to providing an SNDA to such subtenant. A sublandlord should be wary of agreeing in the sublease agreement to provide the SNDA because the sublandlord has no privity of contract with the lender and will need to work through the prime landlord to obtain the SNDA.