

Subleases and Assignments: Drafting Best Practices

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Subleases and assignments serve as exit strategies for tenants seeking to escape from their lease obligations, but there are crucial differences in what they can and cannot accomplish. All commercial leases should have provisions addressing assignments and subleases, as well as the circumstances under which the tenant may assign its lease or sublet the premises. These provisions are often among the most heavily negotiated lease terms between landlords and tenants, and they are of particular importance as businesses evaluate their leased spaces in light of the COVID-19 pandemic.

Assignments vs. Subleases

An assignment is a transfer of all of a tenant's right, title, and interest under a lease to a third party, who assumes the tenant's contractual and common law obligations in a one-time transaction. Following an assignment, the original tenant retains no rights to or interests in the premises. A sublease (sometimes called an under-lease) occurs when a tenant leases all or part of the leased premises to a third party but retains some interest, however small, in the premises. A sublease creates an ongoing relationship between the tenant (the prime tenant) and the subtenant for the term of the sublease. Neither transaction terminates the prime lease, but a sublease creates a new substantive agreement with respect to all or part of the leased premises.

In an assignment, there is no residual tenant interest remaining under the lease between the original tenant (or assignor) and the assignee. Still, because the lease agreement remains in effect, the original tenant remains liable for the assignee's actions as the substitute tenant under the lease. An assignment is always a full transfer of the original tenant's lease rights to a third party. The assignee becomes primarily responsible for paying rent and performing the tenant's lease obligations, and the assignor either may have some guarantor-like responsibility over the assignee's further actions or (if the prime landlord agrees) may be released from the lease altogether.

An assignment may be subject to landlord approval. As of an assignment's effective date, the landlord recognizes the assignee as the tenant and becomes responsible for performing lease obligations for the assignee's benefit. Absent an agreement to the contrary, the assignor remains liable for the assignee's continued performance under the lease. Under the common law, the assignor's liability is joint and several with the assignee, but in practice, it is similar to that of a guarantor: The assignee must perform direct obligations, and the assignor is liable only after a default has occurred and notice has been provided from the landlord to the assignee and assignor.

In contrast, a sublease is an ongoing transaction between the original tenant (or sublandlord) and the subtenant. The subtenant pays rent to the sublandlord, and the subtenant and sublandlord may perform certain obligations for each other's benefit. A sublease may involve only a portion or may involve the entirety of the leased premises. A full sublease is similar in many ways to an assignment, but the crucial difference is that the sublandlord remains responsible for its prime lease obligations, such as paying rent to the prime landlord.

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The sublease will outline the terms applicable to the parties and may be accompanied by a separate prime landlord consent recognizing the agreement. The sublease has a separate term, which cannot extend beyond the prime lease term. Once the sublease term ends, the subtenant must surrender the sublet premises to the sublandlord. Unless otherwise agreed, the sublandlord will remain responsible for payment of rent and performance of other obligations under the prime lease for the remaining prime lease term. The sublandlord will not be released from its obligations under the prime lease. Typically, however, a sublease provides that the subtenant is responsible for its own rent payment to the sublandlord and for performance of some or all “tenant” obligations on the sublet premises.

Importantly, because there is no lease between the prime landlord and the subtenant, there is no privity of contract between the prime landlord and subtenant. The prime landlord will expect the sublandlord to continue to perform under the lease and is under no obligation to accept direct payment or performance from the subtenant.

Risks for Landlords and Lenders

For a landlord, an assignment or sublease presents several risks:

- The assignee or subtenant may not be as good a tenant as the assignor or sublandlord, from either a credit standpoint or because of how diligently it performs the lease obligations.
- The assignee’s or subtenant’s use of the premises may be different from that of the tenant.
- If an assignment occurs earlier in or in the middle of a long lease term, the possibility of a default by the assignee increases because of the potential for adverse financial consequences during the remaining lease term.
- If an assignment occurs late in a lease term or while rental rates have appreciated, the landlord may be prevented from realizing the value of an improved rental market for several years.

In the lease, a landlord should require its prior consent to any assignment or sublease. This gives the landlord the ability to manage the terms of the assignment or sublease and approve the assignee or subtenant. Ideally, the right to consent should be in the landlord’s sole discretion. Alternatively, the landlord may require objective standards for potential assignees or subtenants, such as requiring the assignee or subtenant to have a certain minimum net worth or meet other metrics related to the ability to pay.

To mitigate against potential changes in use, a landlord should include lease language restricting how anyone may use the leased premises. Such restrictions should be made applicable to assignees or subtenants. In *Capital Commercial Properties, Inc. v. Vina Enterprises, Inc.*, 462 S.E.2d 74 (Va. 1995), a tenant had subdivided and sublet shopping center space to various shopkeepers, including a travel agency service. The tenant had an option to extend the lease if it was not in default. When it attempted to exercise that option, however, the landlord claimed the tenant was in default, as acceptable uses on the premises did not include travel agency services. The tenant argued it was entitled to extend the lease because the landlord did not notify the tenant of the default, depriving it of an opportunity to cure. The landlord argued it was not required to notify the tenant of uncured defaults during the period for exercising the renewal option. The court agreed with the landlord: The lease’s plain language for the renewal option did not require the landlord to give the tenant notice of default, even though other provisions required giving the tenant notice and an opportunity to cure.

For long-term assignments or subleases or those entered into near the end of a lease term, the landlord may require a recapture clause. A recapture clause provides that, if there is a proposed assignment or sublease, the landlord may terminate the lease entirely (or only as to the affected part of the premises) and retake possession. The landlord may then lease the premises to a third party. Additionally, the landlord

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may require a relocation clause allowing it to relocate the leased or sublet premises. For instance, if a sublease is for a location that is attractive to other potential tenants, the landlord may relocate the sublet premises and lease the original space to others.

For a lender, an assignment also has risks. For example, the subordination of a lease to a mortgage may not extend to an assignee unless there are specific provisions in the subordination agreement accounting for this. Risk mitigation for a lender depends on two written agreements: the lease between the landlord and the original tenant and the subordination, nondisturbance, and attornment agreement (SNDA) between the original tenant, landlord, and lender. To mitigate risk, an SNDA may contain provisions that automatically extend all of the landlord's rights under the lease relative to a tenant's right to assign to the lender. The lender may take title through foreclosure and would automatically step into the former landlord's shoes in the event the tenant assigns the lease.

Risks for Tenants

Unless the lease has no clause prohibiting an assignment or sublease without landlord consent, the landlord may object to a tenant's request to assign or sublease. Negotiating appropriate lease clauses can mitigate the tenant's risk. When landlord consent is required, the tenant should negotiate limits on consent requirements and create exceptions for assigning or subleasing to tenant affiliates or entities with a net worth similar to or higher than the tenant. For large leased premises, a tenant may even negotiate the ability to sublease portions of the space without the landlord's approval. Furthermore, a tenant should insist on specific standards for landlord approval. The landlord's consent, for instance, should not be unreasonably withheld, conditioned, or delayed, and landlord approval should be deemed given if the landlord fails to respond to an approval request within a certain timeframe.

An example of a tenant-friendly assignment and sublease provision is as follows:

Notwithstanding any provision in the Lease to the contrary, *Tenant may assign the Lease or sublet the Premises or any portion thereof without Landlord's consent, and without incurring any liability, fees or costs relating to the assignment or sublease to any entity that controls, is an affiliate of, is controlled by, or is under common control with Tenant, or to any entity resulting from a merger or consolidation with Tenant (or the sale of all or any portion of the stock of Tenant) or to any entity that acquires all or substantially all of the assets of Tenant (collectively, an "Affiliate"); provided that (i) the assignee or sublessee assumes, in full, the obligations of Tenant under the Lease and (ii) Tenant remains fully liable under the Lease. Except as set forth in this Paragraph ____, Tenant shall not assign the Lease or sublet the Premises, or any portion thereof, without Landlord's prior written consent, which shall not be unreasonably withheld, conditioned, or delayed; provided, however, if Tenant makes an assignment or sublease in violation of this provision, Landlord shall not have the right to terminate the Lease or accelerate the Base Rent unless Tenant agrees to the termination of the Lease upon such assignment or sublease. If the actual rental or other sums received by Tenant from an assignee or sublessee of the Lease or the Premises or any portion thereof exceed the Base Rent payable under the Lease at the time of such sublease or assignment (or, with respect to a sublease or a portion of the Premises, then the share of the Base Rent attributable to such portion), then Tenant shall pay Landlord fifty percent (50%) of such excess sums after Tenant recovers reasonable expenses incurred as a result of the assignment or subletting, such net sums to be payable as Additional Rent under the Lease.*

A tenant also risks having continued liability, because neither an assignment nor a sublease releases the tenant from its lease liabilities unless the lease expressly provides for this. Practically, the risk is higher with a sublease, in which the tenant's direct obligations to the landlord continue indefinitely, compared

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to an assignment, in which the tenant is not typically required to maintain its capital and existence indefinitely. To mitigate this risk, a tenant should request a release from further obligations under the lease. This is more practical for assignments, especially to more creditworthy assignees.

Additionally, if there is a recapture clause, a tenant risks recapture of the premises by its landlord—ending the lease or the tenant’s possession sooner than desired. In negotiations, a tenant should push back on recapture rights under the lease and should try to eliminate any recapture clause or limit it to later periods of the lease term.

Risks for Assignees and Subtenants

The principal risk to an assignee is that the landlord will reject the assignment. Once the landlord approves the assignment, the assignee has no ongoing risks beyond the terms of the lease. The main way to assist an assignor in getting an assignment approved is to be forthcoming with the assignee’s sufficient financial and other information. If an assignee is not a publicly-owned company, however, it may need to protect the confidentiality of its financial information. In such case, the assignee should work with the landlord and assignor to establish a confidentiality agreement early in the negotiations.

Comparatively, the main risk for a subtenant is that it lacks privity of contract with the prime landlord. If the sublandlord defaults under the prime lease, the subtenant has no common law right to cure or continue to possess the leased premises. To mitigate this risk, the subtenant should obtain recognition from the prime landlord that allows the subtenant to receive notice of any lease defaults by the sublandlord and to cure such defaults on the sublandlord’s behalf.

A prime landlord’s consent is usually evidenced by a document, such as a letter or other short-form document, confirming the consent and maintaining the prime landlord’s and sublandlord’s obligations under the prime lease. Sometimes, a subtenant may be able to require a full-scale agreement with the prime landlord to recognize the consent and delineate certain understandings between the parties, such as the subtenant’s right to cure sublandlord defaults. Another way to mitigate the risk of sublandlord default is to have a provision in the sublease giving the subtenant the ability to perform the sublandlord’s nonmonetary obligations under the prime lease, such as maintenance, cleaning, or security.

Drafting to Mitigate Sublease Risks

Generally, one of the key issues in subleases is coordinating the sublease with the prime lease to ensure both documents operate in a coherent fashion and do not contradict one another. The major provisions to consider include the following:

- **Term:** Ensure that the sublease term does not extend beyond the prime lease term.
- **Sub-subleases:** Ensure that “sub-subleases” cannot be granted in a manner that would contradict the prime lease’s anti-assignment terms.
- **Subtenant Rights:** Ensure the subtenant’s rights to use the premises or building amenities do not exceed the sublandlord’s rights under the prime lease.
- **Cure Periods:** If the subtenant has the right to cure sublandlord defaults, the cure period should leave enough room for the sublandlord to cure the defaults in the event the subtenant fails to cure.

One of the best ways to ensure that the sublease and prime lease do not contradict one another is to incorporate as many provisions as possible by reference from the prime lease into the sublease. In essence, such a provision would state that the sublandlord is treated as the landlord under applicable terms of the prime lease, while the subtenant is treated as the tenant under the prime lease. The principal difference is that the sublandlord is not responsible for the prime landlord’s responsibilities as the actual landlord under the prime lease, as the sublandlord does not control the building. Instead, the sublandlord’s main

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responsibility is to request the prime landlord to perform its services as required under the prime lease.

The lack of a contractual relationship between a subtenant and prime landlord ultimately benefits the prime landlord, as it does not have to contend with multiple entities for a single space: It has an existing lease with the sublandlord and can demand performance without needing to engage with subtenants. The legal effect on a sublease in the event of a sublandlord default is its termination. The sublease is discharged as a matter of law, with the subtenant losing its right to occupy the leased premises at the same time as the sublandlord.

Because of a subtenant's high stakes, it needs to protect itself from the possibility that a sublandlord default will terminate the subtenant's right to possession. In a sublease, a subtenant should negotiate provisions that require the sublandlord to provide the subtenant with notice of any prime lease defaults and an opportunity to cure them during the applicable cure period. As between the subtenant and prime landlord, the prime landlord's consent document should contain provisions recognizing the subtenant's continued occupancy of the premises and the subtenant's right to remain in place under a direct lease with the prime landlord. The latter option, however, is not universally acceptable to landlords because it requires an especially creditworthy subtenant that is subleasing all or a substantial portion of the premises for the duration of the lease term.

Conclusion

Assignments and subleases are attractive for businesses that have adapted to the challenges of the COVID-19 pandemic and have reconsidered their current needs in leased spaces. Whether reviewing existing leases or entering new agreements, parties should understand their rights and obligations for assigning and subleasing. When preparing subleases, lawyers must take care to coordinate the sublease with the terms of the prime lease.