

Subleasing as an Extreme Sport:
when things go wrong

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In the first 2 parts of this presentation, you learned the special due diligence and documentation required in Subleasing. This section will discuss default, foreclosure and bankruptcy and its impact on your rights and remedies as a Subtenant.

1) Default by Tenant or Landlord and termination of Master Lease

As a Subtenant, if the only agreement signed is a Sublease, with no recognition or non-disturbance agreement from the Landlord, the Subtenant is at risk of losing its sublease if the underlying Master Lease is terminated by either a Tenant or Landlord default. In some states, because the Subtenant is in possession of all or a portion of the leased premises, a separate eviction action would need to be brought against the Subtenant in addition to evicting the Tenant, if the Landlord knew or should have known that a separate party was in possession of the leased premises. Unless the underlying default is cured, this separate eviction action may do nothing but buy a Subtenant time before they need to move because the Sublease is ultimately a junior interest to the Master Lease. Once the Master Lease is gone, the Sublease is gone as well.

Practice Pointer: Negotiate a provision with the Landlord regarding Consent to the Sublease which relates not only to Consent, but also determines the rights of the parties in the event of a Termination of the Master Lease. Landlords will not always agree to this unless the Subtenant agrees to step into the shoes of the Tenant and perform all obligations

of Tenant, at least with respect to the Subleased Premises. The provision in the Consent could look something like the following:

Termination of Master Lease. If the Master Lease terminates prior to the expiration of the Sublease term (provided that Landlord and Tenant agree they shall not voluntarily terminate the Master Lease prior to its expiration date), at Landlord's/Subtenant's option, Subtenant shall: (a) attorn to Landlord and enter into such reasonable documents as Landlord shall request in connection therewith; or (b) quit and surrender the Sublease Premises, repairing all damage caused by Subtenant including by the installation or removal of Subtenant's property, provided that before Subtenant is required to quit and surrender the Sublease Premises, Landlord and Subtenant shall negotiate in good faith to determine if they can agree on the terms of a new direct lease between Landlord and Subtenant, and if a new lease has not been executed by the date that is _____ () months after the termination of the Master Lease, then Subtenant shall have the right to remain in occupancy of the Sublease Premises for an additional period of _____ () months in order to find suitable new premises, and Subtenant's occupancy during this period after the expiration of the Master Lease shall be upon the rental and other terms of the Sublease. Tenant agrees that in the event of such attornment, Tenant shall, upon the written demand of Landlord, immediately pay or transfer to Landlord any security deposit, rent or other sums then held by Tenant from Subtenant. In the event of attornment under clause (a), Subtenant shall thereupon be bound to Landlord and Landlord shall be deemed to be the sublandlord for all purposes under the terms of the Sublease during the remaining term thereof except that Landlord shall not be:

(i) Bound by any payment of Sublease Rent in advance or other sums which Subtenant may have paid to Tenant other than Sublease Rent paid for the current month;

(ii) Bound to return or apply any security deposit paid to Tenant and not actually received by Landlord;

(iii) Bound by any modification or amendment made to the Sublease without Landlord's written consent;

(iv) Responsible for any act, default or neglect of Tenant and Subtenant shall be obligated to pay all rents and other charges under the Sublease without offset or abatement by virtue of any such act, default or neglect of the Tenant, including without limitation any deferred maintenance or other failure to repair, replace or maintain any improvements on the Premises;

(v) Responsible for any obligation of Tenant to improve the Sublease Premises or any other part of the Premises and the covenant of Subtenant to pay Sublease Rent and otherwise to perform under the Sublease shall be entirely independent of any obligation of the Tenant to construct any improvements;

(vi) Bound by any option or right of first refusal including the rights granted in Section 16 of the Sublease;

(vii) Obligated to provide any services that Tenant has agreed to provide such as copying equipment, reception or other services except for those services required in its role as Landlord under the Master Lease;

(viii) Obligated to rebuild or restore or replace the Sublease Premises or any other improvements following damage or destruction except to the extent it is obligated to do so under the Master Lease;

(ix) Bound to recognize or provide any rent credit to Subtenant pursuant to Section ____ of the Sublease;

(x) Bound by any standard contained in the Sublease governing approval or consent by Sublandlord and all such approvals and consents shall be governed by the standards set forth in the Master Lease;

(xi) Bound by or deemed to have made any of the representations, warranties and covenants made by Sublandlord under Section ____ of the Sublease;

(xii) Obligated to recognize any offset permitted under the terms of Section ____ of the Sublease;

(xiii) [add other carveouts to the obligations or differences in the provisions of the Lease and Sublease so that Landlord will sign this consent.]

Although a written agreement regarding the rights of a Subtenant in the event the underlying Master Lease is terminated is the best case scenario, as a practical matter, in this market, if a Subtenant does not have such an agreement, but they are willing to pay close to market rates for the Subleased Premises, most Landlords will accept a cure and negotiation of an occupancy agreement from a Subtenant, rather than having additional vacancies.

Practice Pointer: If a Subtenant cures a Tenant's default based on Landlord's agreement to keep the Subtenant in place, get the agreement in writing. See Syufy Enterprises, L.P. v. City of Oakland, 104 Cal. App. 4th 869 (2002) as an example of a trusting Subtenant who

relied upon assurances from the Master Landlord. Unfortunately, when the underlying Lease was terminated, so were the rights of the Subtenant.

In some jurisdictions, a Subtenant may win a damages argument based on the contract rights in the Lease or Sublease, and the Subtenant would have claims under a theory of detrimental reliance. Even in the states in which the damages arguments favor the Subtenant, the Subtenant will still lose possession if the underlying Master Lease is terminated and the Subtenant does not otherwise have a separate written recognition or non-disturbance agreement with the Landlord (and Landlord's Lender) in place.

2) Foreclosure and Bankruptcy

In the due diligence process, prior to signing the Sublease, hopefully the Subtenant not only visited the property, but also performed some due diligence on the building as a whole. One easy item that is routinely missed in the due diligence process is looking at the vacancies in the entire building. An empty building may mean that the Landlord is not paying debt service and is about to lose the asset to foreclosure. Even with a recognition agreement from the Landlord, unless the Lender also signs that agreement, some states permit a foreclosing lender to terminate all leases in their foreclosure process.

Practice Pointer: When reviewing the lease documents, ask about the subordination/non-disturbance agreement between Tenant and Lender.

Most subordination/non-disturbance agreements, if they are in place, contain a provision that the terms are binding on successors and assigns. Because this subordination/non-disturbance agreement from the Lender may be a Subtenant's only hope to stay in place, in addition to the various terms negotiated with respect to the rights under the Lease, a Subtenant will want its

Sublease to specifically state that it is a successor to Tenant's interest in the subordination/non-disturbance agreement, with respect to the Subleased Premises and that Tenant will not voluntarily agree to a termination of the Master Lease without Subtenant's consent.

Practice Pointer: A successors and assigns provision that would benefit a Subtenant in the subordination/non-disturbance agreement may look like the following:

Successor and Assigns. The provisions of this Agreement shall be binding upon and inure to the benefit of the parties hereto and their respective successors and assigns. The words, "Lender," "Borrower" and "Tenant" shall include their respective heirs, legatees, executors, administrators, beneficiaries, successors, subtenants and assigns.

After finding the "Successors and Assigns" language in the subordination/non-disturbance agreement, be sure to confirm that the subordination language not only has attornment language, but also a non-disturbance provision. Because some Tenant use foreclosure as a way out of their lease, it would be best if the Subtenant were able to have the recognition provision noted above also acknowledge by Landlord's lender.

Practice Pointer: In the Sublease, specifically address whether or not the Tenant can (i) appear in a foreclosure action, and (ii) negotiate with the Lender regarding the Subleased Premises with or without the participation of the Subtenant. Subtenants who require the Landlord to include Subtenants in the process stand a better chance of surviving a foreclosure in possession of the Subleased Premises.

Bankruptcy can have a similar or worse effect as a foreclosure depending on which party has filed bankruptcy. Under Section 365 of the Bankruptcy Code, a bankruptcy trustee (or debtor in possession) may assume or reject leases after filing for bankruptcy protection . If the Landlord has filed for bankruptcy, the analysis is the same as the default or foreclosure discussion above because of the risk of loss of the lease if the Landlord rejects the Master Lease. See Syufy, referenced above. If the Tenant files for bankruptcy and rejects the Lease, all may

not be lost. If the Subtenant has properly negotiated a recognition agreement with the Landlord, when the Tenant rejects the lease, the Subtenant can rely upon the provisions in the recognition agreement to determine its rights with respect to the space. See Block Props. Co., Inc. v. American National Ins. Co., 998 S.W. 2nd 168 (Mo. Ct. App., 1999) for an example of a court's application of state law which determined that a Tenant's rejection of the Master Lease and Sublease did not terminate the Subtenant's right to possession of the Subleased Premises (before relying on this case, please see specific facts, as full rent was paid under the Master Lease after Tenant's rejection so the court found there was no substantial breach of the Master Lease and Subtenant was permitted to continue to occupy the Subleased Premises).

Practice Pointer: Do not ignore bankruptcy notices. An upstream bankruptcy which terminates a Master Lease can terminate a Subtenant's possessory interest in the Subleased Premises.

3) Conclusion

A written agreement between all of the various parties to the Sublease (i.e. not just the Subtenant and Tenant, but also the recognition agreement with Landlord and Landlord's Lender) is the best possible scenario for the protection against the various risks of default, foreclosure or bankruptcy. Because market conditions do not always give Tenants or Subtenants strong negotiating power when these agreements are first proposed, Subtenants in today's economy should use the increased vacancy rates in many areas to strengthen their current position in these negotiations. If Tenants and Subtenants have an eye toward the entire picture of Landlord's financial condition, a savvy Subtenant can protect itself from some of these risks.