

Differences of Assignments and Subleases at Law and Other Basics of Lease Transfers

ANN PELDO CARGILE
MICHAEL B. NOBLE

I. INTRODUCTION

Assignments and subleases are commonplace. The difference between the two is a product of common law. Without a thorough understanding of the differing rights of landlords, tenants, and transferees resulting from assignments and subleases, parties may find themselves unpleasantly surprised. This chapter outlines the fundamental differences between assignments and subleases, how the common law arranges the ongoing rights among the parties, and the advisability of certain express agreements that change the common law results.

II. DISTINGUISHING BETWEEN AN ASSIGNMENT AND A SUBLEASE

The quantity of interest transferred distinguishes an assignment from a sublease. This distinction can be summarized as follows:

Assignment. If a tenant transfers its entire interest in a leasehold estate, the transfer is an assignment. To qualify as such, the transfer must include the tenant's entire estate for the duration of the lease.

Sublease. If a tenant transfers less than the remaining term or less than the tenant's entire estate, thus leaving the original tenant with a reversionary interest in the lease, the transfer is a sublease.

For these purposes "estate" is tantamount to "term." Determination of whether a tenant has retained a portion of the estate does not depend on whether the tenant receives less rent than it owes under the lease, or even on whether the tenant

transferred the entire premises. An assignment can occur regardless. However, retention by the tenant of even the smallest right with respect to the term constitutes a “reversionary interest” and creates a sublease. For instance, courts have construed a transfer as a sublease where the original tenant retained an option to terminate, extend, or renew the prime lease. In fact, the reversionary interest need not even be under the control of the original tenant to qualify the transaction as a sublease. At least one court has held that a tenant may have retained a reversionary interest if a third party to whom premises are conveyed has the option to terminate the conveyance.¹

Surprisingly, one factor that does not distinguish an assignment from a sublease is the portion of premises involved. As long as the tenant relinquishes its interest in the portion of the premises transferred for the entire term of the lease, an “assignment pro tanto” occurs. Such a transfer carries all the legal implications of any other assignment, except that the assignee has liability for only the portion of the rent proportionate to the interest it receives in the premises. This is an exception to the definition of sublease given above; though less than the entire premises has been conveyed, this type of transfer actually creates a form of assignment. As a result, the assignee will have privity of estate with the landlord, and may have privity of contract as well.

Landlords and tenants may not find pro tanto assignments desirable. A landlord will be concerned about dealing with two separate tenant interests under one lease document. For instance, what if the original tenant defaults under the lease with respect to its space, but the assignee continues to meet its obligations under the lease for its portion of the premises? Would the landlord be forced to terminate the lease for only a portion of the premises? The landlord certainly did not intend this result when it entered into the lease. The landlord might be able to control this risk if the lease requires its consent for a transfer, but what if the lease is silent? From the assignee’s or tenant’s perspective, what if it wants to terminate the lease? Can it do so without the consent of the other party? What if either the tenant or assignee becomes bankrupt? If the trustee of the bankruptcy estate rejects the lease, is the assignment terminated? No easy answers exist for these issues. Comprehensive transfer provisions in leases and assignment documents provide the only real solution.

III. WHAT’S AT STAKE: THE LEGAL IMPLICATIONS OF IDENTIFYING A TRANSFER

A. Privity of Estate versus Privity of Contract

The classification of a leasehold transfer as an assignment or sublease carries differing legal implications regarding future liability arising under the prime lease.

1. See *Orchard Shopping Ctr., Inc. v. Campo*, 485 N.E.2d 1248 (Ill. App. 5th 1985) (holding that where, as a term of a lease transfer, a sublessee retains the right to terminate the sublease for any reason upon seven days’ notice, a reversion is retained by the transferor and, as a result, the transaction is a sublease). See also *Indian Ref. Co. v. Roberts*, 181 N.E. 283 (Ind. App. 1932).

A party's liability under the terms of the prime lease ultimately depends upon the somewhat archaic term of "privity." The common law recognizes two general types of privity: privity of estate and privity of contract.

Privity of estate. Privity of estate rests upon a landlord-tenant relationship. Acquisition of a leasehold interest by the new tenant, regardless of whether it is an assignment or sublease, establishes privity of estate.

Privity of contract. Privity of contract rests upon the existence of an agreement, regardless of whether a landlord-tenant relationship exists. Privity of contract does not run with the land, unlike privity of estate. Accordingly, the original lease will not bind a new tenant under privity of contract unless the new tenant assumes the lease.

The original landlord and tenant under a lease have both privity of estate and privity of contract. When the original tenant transfers its interest in the lease to a third party, these relationships inevitably change. The manner and extent of the transfer determine what forms of privity will thereafter exist.

B. Assignment

If the original tenant assigns its interest in the lease, its privity of estate terminates, but its privity of contract remains intact. In other words, assignment of the lease ends the original tenant's right to possession, but, absent an express release under the terms of the lease, its liability under the lease continues. When the assignee takes possession of the premises, the assignee obtains privity of estate. Privity of estate binds the landlord and assignee to the terms of any covenants running with the land, but only so long as the privity of estate continues. As a result, the assignee becomes liable to the landlord for the payment of rent and the breach of any other lease covenants running with the land. Likewise, the landlord becomes liable to the assignee for the covenant of quiet enjoyment. However, the assignee does not come into privity of contract with the landlord unless the assignee expressly assumes the tenant's obligations under the lease. Without an assumption, the assignee would not be liable for contractual agreements that do not run with the land, such as an original tenant/assignor's undertaking to pay a note made in favor of the landlord.² Further, absent the assignee's assumption of the lease, a subsequent assignment will end the assignee's privity of estate, and with it, all of that party's obligations to the landlord. Thus, the absence of privity of contract between the landlord and assignee prevents the assignee from being liable for any breach committed by the original tenant or any prior or subsequent assignee.

As previously alluded to, the tenant cannot relieve itself from liability under the lease merely by assigning the lease to a third party. Even with an assignment, the tenant remains secondarily liable for the obligations of the assignee under the lease. This means that if the landlord cannot recover from the assignee, it can then

2. Gateway Co. v. DiNoia, 654 A.2d 342 n.8 (Conn. 1995); Dolph v. White, 12 N.Y. 296 (1855).

pursue the tenant. However, most landlords would prefer to pursue either or both of the tenant and assignee, at landlord's election and without exhausting remedies against one or the other. To achieve this end, the lease must expressly provide that the original tenant remains *primarily* liable notwithstanding a transfer of its interest.

If the assignee assumes the obligations of the tenant under the lease through agreement with the assignor, *both* the tenant and the assignee have privity of contract, while only the assignee has privity of estate. The landlord can enforce the lease against the assignee as a third-party beneficiary, regardless of whether the landlord was a party to the assignment/assumption agreement. However, some jurisdictions have held that in limited circumstances, when a landlord has accepted the assignee in place of the assigning tenant, either expressly or by implication, the assigning tenant is released from liability arising under the terms of the lease.³

Notwithstanding its initial liability under the lease following an assignment, the original tenant may later be released from liability if the terms of the lease are amended by agreement between the landlord and the assignee. Thus, from the landlord's perspective, it is important for the lease to provide that the tenant remains liable, at least for the initial lease obligations, regardless of any later amendment of the lease terms.

C. Sublease

A sublease, unlike an assignment, does not establish privity of estate or privity of contract between the landlord and the subtenant. Instead, when a sublease occurs, the original tenant retains both privity of estate and privity of contract with the landlord. No legal relationship exists between landlord and subtenant, despite the subtenant's possession of the premises. A sublease, therefore, does not transfer any of the original tenant's rights or obligations under the lease to the subtenant. Accordingly, the landlord cannot hold the subtenant liable for a breach of the lease, even if caused by the subtenant, nor can the subtenant enforce the terms of the lease against the landlord.

Though the landlord and subtenant do not have privity, a sublease does establish a new leasehold estate between the tenant and subtenant, creating both privity of estate and privity of contract. Thus, the sublease document will control whether and to what extent the subtenant can hold the tenant liable for breaches of the lease by the landlord, and what happens if the subtenant's failure to perform under the sublease creates liability for the tenant under the lease. These agreements do

3. See *185 Madison Assocs. v. Ryan*, 174 A.D.2d 461 (N.Y.A.D. 1991) ("It is well settled that in order to relieve the original tenant-assignor from its continuing liability after assignment, it must be expressly shown that the lessor not only consented to the assignment, but accepted the assignee in place of the tenant and such release of the tenant must either be express or implied from facts other than the lessor's mere consent to the assignment and its acceptance of rent from the assignee[.]"). *But see* *De Hart v. Allen*, 161 P.2d 453 (Cal. 1945) (maintaining that an assignor/lessee of lease remains as primary obligor under the lease).

not, however, disturb the privity of contract and estate existing between the landlord and tenant. Thus, for either the landlord to have rights against the subtenant or vice versa, the landlord and subtenant must execute a separate document establishing them.

IV. CONSENT, WAIVER, AND BREACH

The law favors free transferability of rights. As such, a party may prohibit assignment or subletting only through the use of express prohibitions in the lease. Absent such prohibitions, tenants may sublease or assign their leasehold interests freely. However, simple restrictions on transfer in the lease may not be sufficient. Many courts perceive restrictions against assignment or sublease as restraints on alienation. As a result, courts often interpret restrictive language against the landlord. For instance, a prohibition only against assignments does not preclude subleases, and vice versa.⁴ Furthermore, under the majority rule, a simple covenant against subletting would not bar subletting only a portion of the premises.⁵

Some states have enacted statutory limitations upon a tenant's right to transfer its leasehold interest. For instance, a Texas statute prohibits tenants from subleasing or assigning a leasehold interest without the consent of the landlord.⁶ Other states have adopted similar restrictions, but only as to short-term leases.⁷

Given the common law, and absent satisfactory statutory provisions that change the common law result, most leases contain language requiring landlord consent for transfers of the tenant's leasehold estate. Where a requirement for landlord consent exists, in most jurisdictions the tenant's failure to obtain such consent will enable the landlord to recover damages. However, in certain circumstances or where a statute or the language of a landlord consent requirement expressly provides, a landlord may be able to declare the assignment or sublease void, sue the tenant for breach of covenant, or obtain an injunction.⁸ It is important to note, however, that the breach of covenant prohibiting assignment

4. See, e.g., *Bd. of Comm'rs v. Lions Del. Cnty. Fair, Inc.*, 580 N.E.2d 280 (Ind. App. 1991); *Smith v. Hegg*, 214 N.W.2d 789 (S.D. 1974); *Gagne v. Hartmeier*, 611 S.W.2d 194 (Ark. App. 1981); *Rogers v. Hall*, 42 S.E.2d 347 (N.C. 1947). See also 1 MILTON R. FRIEDMAN, *FRIEDMAN ON LEASES* § 7:3.3 (5th ed. 2004 & Supp. 2012).

5. See *Drake v. Eggleston*, 108 N.E.2d 67 (Ind. App. 1952). For the minority view, see *Minneapolis, St. Paul & Sault St. Marie R.R. v. Duvall*, 67 N.W.2d 593 (N.D. 1954).

6. Tex. Prop. Code Ann. § 91.005 (1995), discussed in *718 Assocs., Ltd. v. Sunwest N.O.P., Inc.*, 1 S.W.3d 355 (Tex. App. 1999); *Lawther v. Super X Drugs of Tex., Inc.*, 671 S.W.2d 591 (Tex. App. 1984).

7. See FRIEDMAN, *supra* note 4, § 7.301 (citing *Sooner Pipe & Iron Co. v. Bartholomew*, 248 P.2d 225 (Okla. 1952)).

8. See generally *Shropshire v. Prahalis*, 419 S.E.2d 829 (S.C. App. 1992) (allowing a forfeiture remedy where the lease contained a forfeiture clause); *Clasen v. Moore Bros. Realty Corp.*, 413 S.W.2d 592 (Mo. App. 1967); *Artesia Med. Dev. Co. v. Regency Assocs., Ltd.*, 214 Cal. App. 3d 957 (Cal. 2d Dist. 1989); *Twelve Oaks Tower I, Ltd. v. Premier Allergy, Inc.*, 938 S.W.2d 102 (Tex. App. 1997) (providing that under a Texas statute, failure by a tenant to obtain consent to assignment renders the lease voidable at option of lessor, and is not terminated unless landlord undertakes to terminate it, declare forfeiture, or reenter). See also FRIEDMAN, *supra* note 4, § 7.304.

or sublease does not in and of itself terminate the lease.⁹ While an assignment in breach of the restriction may provide the basis for forfeiture, the assignee will still receive good title to the lease as a result of the assignment. As such, the landlord is still entitled to recover rent from the assignee despite the breach.¹⁰

To ensure that the landlord can terminate the lease or void an unauthorized transfer regardless of jurisdiction, the lease should expressly provide such rights, at its election. A landlord may, however, waive the breach of a transfer restriction against or otherwise prevent itself from objecting. As such, although a lease may prohibit assignment or sublease without consent, the landlord may expressly, or by implication, be deemed to have waived a transfer in violation of the lease by acting in a manner that implies that the breach of this covenant has been waived. For instance, the landlord's knowing acceptance of rent from an assignee or subtenant may constitute such a waiver and prevent the landlord from declaring a lease forfeiture.

Another pitfall arises after a landlord has either consented to a transfer or waived a breach of a nonassignment clause. Unless the lease expressly provides to the contrary, the restriction on transfer will terminate for future transfers.

V. PRACTICAL ASPECTS

The difference between an assignment and a sublease can be small indeed—for example, a transfer for the full term constitutes an assignment, while a transfer for one hour less constitutes a sublease. In either case, the original tenant will remain liable to the landlord for the lease obligations, yet the rights of the landlord and transferee will differ. In case of an assignment, the assignee will at least have privity of estate and therefore certain rights against the landlord and vice versa. In case of a sublease, the subtenant has no rights against the landlord, and the landlord has no rights against the subtenant.

Each party will have different goals. The landlord will want to enforce the lease against both the tenant and the transferee to the maximum extent possible. It would therefore prefer an assignment in which the tenant agrees to remain primarily liable under the lease. The transferee will want the freedom to enforce the essential lease obligations against the landlord with minimum liability. It would therefore prefer an assignment without assumption. The tenant would prefer to have either total absolution or total control. Thus, it may prefer an assignment with assumption by the assignee and release of the tenant. If the tenant cannot absolve itself of liability under the lease, it may opt for the other end of the spectrum, and create a sublease, retaining a nominal portion of the estate, in order to prevent the transferee from having direct dealings with the landlord.

Any of the foregoing results and infinite variations can arise. The trick comes in making the results intentional. A tightly crafted transfer clause in the

9. See *Chessport Millworks, Inc. v. Solie*, 522 P.2d 812 (N.M. 1974); *Cities Serv. Oil Co. v. Taylor*, 45 S.W.2d 1039 (Ky. 1932).

10. See *Klee v. United States*, 53 F.2d 58 (9th Cir. 1931); *Fink v. Montgomery Elevator Co.*, 421 P.2d 735 (Colo. 1975).

lease provides the best solution. The following list comprises the key elements to include:

- No transfer of all or any portion of the premises or the tenant's leasehold estate may occur without the landlord's consent.
- Any transfer without the landlord's consent is voidable, at the landlord's option.
- Any transfer without the landlord's consent may result in a forfeiture of the lease, at the landlord's option.
- The acceptance of rent by the landlord from any transferee will not be deemed to be a waiver of the landlord's right to consent or declare the lease forfeited or the transfer void.
- The landlord's consent to one transfer will not be deemed to be a waiver of the right to consent to any future transfer.
- Following an assignment, the tenant will remain primarily liable under the lease. If the assignee defaults, the landlord may proceed directly against the tenant without the necessity of exhausting remedies against the assignee.
- The landlord may consent to subsequent sublettings or assignments or amendments or modifications to the lease by transferees without notifying the tenant, and without obtaining the tenant's consent thereto. No such actions will relieve the tenant from primary liability under the lease.

VI. CONCLUSION

Under the common law and some state statutes, assigning and subletting create specific sets of rights among the landlord, tenant, and transferee. These preestablished results may be undesirable from the standpoint of the parties and the structure of a particular transaction. Thus, drafting a comprehensive transfer clause plays an essential role in ensuring results consistent with the expectations of the parties.