Landlord Impediments to Subleasing and Assignment

Issues with Landlord's Consent

By Sidney G. Saltz

Most tenants, when they lease space, intend to occupy that space for the duration of the term of their lease. They do not anticipate subleasing the space or assigning the lease. Sometimes, however, there are situations in which a tenant may lease more space than it needs at that time because it expects to grow into it, or a tenant may lease space intending to share it with a complementary business. When the tenant knows in advance that it will be subleasing a part of the space, that fact should be brought to the landlord's attention at the time the deal is negotiated, and the lease should be drafted to permit those subleases. Such situations, however, are the exception rather than the rule. This article explores, from a tenant's perspective, common lease restrictions on the transfer of the tenant's interests and changes their lawyers can negotiate to such restrictions to enhance tenant rights.

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Reasons for Transfers

Why might a tenant decide to sublease its space, and what events might cause a tenant to desire to assign its lease? The answers spring from changes in the tenant's business, some good and some bad. Certainly the decision to sublease or assign is not made lightly, because every sublease or assignment creates costs and risks that were not anticipated at the time of the original lease negotiation.

A tenant might decide to sublease if it outgrows the space and can no longer use it profitably. On the other hand, the tenant's business may have declined and it no longer needs some, or even all, of the space. The tenant may be in very bad financial condition and may be seeking to minimize its exposure in its struggle to remain in business. The tenant may have

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acquired another company or been acquired, and a determination is made to consolidate in another location. A tenant is more likely to decide to sublease rather than assign in each of those situations, particularly if it is disposing of only a portion of its premises. A sublease is preferable and more common than an assignment—even though it keeps the tenant in the middle—because it affords the tenant control over the subtenant and enables the tenant to re-enter the premises if the subtenant defaults, either to operate there itself or to sublease the space to another party. Assignments are most commonly used when the business is sold. Assignments have a disadvantage for the tenant in that the tenant generally remains liable under that lease but, if the assignee defaults, the tenant is not in a position to mitigate its damages.

Consent Required

In the absence of any contrary provision in the lease, the tenant's right to sublet or assign is unfettered; because the law favors free transferability of interests, the landlord's consent is not required. See 1 *Friedman on Leases* § 7.2 (5th ed. 2004); but see id. § 7.301 (statutory restrictions). It is for that reason that nearly all leases provide that the tenant may not sublet, assign, or otherwise transfer its interest without the prior written consent of the landlord.

Some leases exclude certain transfers from the requirement for the landlord's consent. For example, transfers to related entities, such as subsidiaries, parent entities, or affiliates, may be permitted without consent. Mergers or consolidations are often excluded. Even the sale of the business often can be negotiated as not requiring consent, usually conditioned on the transferee having good financial credentials.

When consent is required, many landlord-drafted leases provide for an extended period, such as 60 days, for the landlord to decide whether to consent to the sublease or assignment. That is a deal-killer right there, because, in most cases, the prospective subtenant or assignee will not wait that length of time for a decision. Landlords have no reason to take that long to consent or withhold consent, and many landlords are willing to shorten that period considerably.

Consent Not Unreasonably Withheld—Standards

Most leases provide, either before or after negotiation, that the landlord's consent will not be unreasonably withheld. Admittedly, that is a somewhat vague standard, but it is a standard

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nonetheless, and one that courts feel they can apply after an examination of the factual circumstances in the particular case. See *Friedman* § 7.304(e). Still, landlords are frequently not content to give courts the discretion to determine what is reasonable and what is not, so leases may contain a list of standards in which a denial of consent may not be deemed unreasonable.

Some of the common standards are:

1. The tenant may not be in default under the lease.
2. The proposed use of the premises after the subletting or assignment may not be detrimental to the property.
3. The proposed sublessee or assignee must be acceptable, financially and otherwise.
4. The proposed sublessee or assignee may not be a government agency.
5. The proposed sublessee or assignee may not be a tenant in the building.
6. The proposed sublessee or assignee may not then be negotiating with the landlord for a lease on the property and may not have negotiated with the landlord for space on the property within the prior 12 months.
7. The proposed rental rate in the sublease may not be lower than that quoted by the landlord for comparable space on the property.

Two of the standards relate to the character of the proposed sublessee or assignee, three are anticompetitive, and two have other purposes. Each warrants further discussion.

It is difficult to see a reason for standard 1, although that condition is very common. It seems that it should be in the landlord's interest to have any defaults cured by the tenant, if it is possible. How does it harm the landlord to permit the sublease or assignment if the default is cured as a condition of the consent? Note that the standard is not stated in terms of a default having occurred "with the time to cure expired." But, even if the cure time has expired (and the landlord has the right to pursue its remedies), it still may be advantageous for the parties to permit the transfer to go forward. In the jurisdictions where the landlord is obligated to mitigate its damages, it may be risky for the landlord to refuse consent to a sublease or assignment.

Standard 2 is pretty vague. What may be detrimental to the property? Bear in mind that if the use in the lease is limited to a specific purpose, as it should be, the transferee will not have the right to put the premises to a different use, unless the landlord consents to the change. Another use would constitute a breach of the lease. For example, if the tenant is already using the premises to compound chemicals and the prospective sublessee or assignee is intending to use them for the same purpose, the landlord should not have the right to withhold consent. A retail tenant obligated to pay percentage rent may not, without the landlord's agreement, lease its space for warehousing. On the other hand, a transfer by a tenant that uses an office for general office use with very little traffic and very little demand for parking to another general office user who does have a lot of traffic

can be detrimental. Certainly it is preferable to consider and recite, at least as examples, what might be detrimental in the particular situation.

Standard 3 is stated in vague terms deliberately. The language in a lease is often more extensive. The landlord is concerned about several things. First, is the transferee financially able to perform its obligations? It may be argued that the tenant remains liable, so the credit of the transferee is inconsequential. Although the tenant probably remains liable, that does not solve the landlord's problem. The landlord has a legitimate interest in seeing that the occupants of its property can perform; it is not interested in having a lawsuit against the transferor. Some leases go so far as to include a standard for the financial capacity of the transferee. For example, the landlord may require that the transferee have a specified net worth or a net worth equal to or greater than that of the tenant at the inception of the lease. Those standards can present impediments to a transfer. To take an extreme example, requiring a transferee to have a net worth equal to Microsoft's would be absurd. Even a net worth requirement of several million dollars may seriously limit a strong transferor's ability to transfer its interest. Of course, it is the strongest companies that usually have the most ability to negotiate limitations on the landlord's ability to reject a sublease or assignment.

Second, does the transferee have the experience to operate the business in the premises? This is particularly important in the retail area. For example, no landlord wants its restaurant operator to sublease or assign to someone who has never operated a restaurant; if the business closes, it could affect the traffic to other stores on the property.

Third, does the transferee have a good reputation in the community? This can really be a way for the landlord to exclude persons who are suspected of ties to organized crime or who have unsavory backgrounds. It should never be a basis to exclude persons because of race, religion, or other such characteristics.

The landlord's concern in standard 4 is understandable. Many landlords will not lease to government agencies for any number of reasons, two of which are that government agencies tend to be very poor housekeepers and that the lease (or sublease) must generally be on the government's form, which is not very favorable to landlords. But, if the property is located in a state capital or in Washington, D.C., the landlord may be more sympathetic to those transfers.

Standards 5, 6, and 7 are designed to prevent the tenant from competing with the landlord for prospective tenants on the property. Many landlords are very wedded to these standards,

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but are they really fair? Even before discussing the specifics of these three conditions, we should consider whether it is legitimate for a landlord to impose those conditions on tenants. This article started with a discussion of the reasons a tenant may wish to sublease its space or assign its lease. The circumstances described are real business events being dealt with by tenants in actual situations. The tenant is not seeking to sublease or assign for the purpose of damaging the landlord. It is trying to minimize its costs in a situation that arose after the lease was signed and was not anticipated at that time.

Consider whether an assignment actually does compete with the landlord's ability to lease other space. Although an assignee succeeds to the interest of the tenant under the lease, it buys into the lease as negotiated at an earlier time by the tenant. The remaining term may be less than the term under a new lease, the assignee may not get the benefit of any new build-out, and the assignee is stuck with the deal negotiated by the assignor. In the author's judgment, the landlord should have very little or no right to hold up a tenant's sale of its business.

In the sublease situation, the threat of competition with the landlord is even less relevant. There is no question that a sublease is much less favorable to the sublessee than a direct lease with the landlord. The sublease is dependent on the continued financial viability of the tenant and the subtenant is subject to dispossession if the tenant defaults under the prime lease. The sublessee's risk is even greater if the sublease is for less than the entire premises leased to the tenant, because the tenant may commit a nonmonetary default on the premises it still occupies. The remaining term of the prime lease is probably shorter than the terms of new leases being written for the property, because the tenant will most likely have been in possession for some time. The subtenant has no privity with the landlord and thus cannot enforce the rights of the tenant under the lease, except through the tenant. The subtenant has only limited ability to negotiate the terms of the deal, especially if the lease was made in a "landlord market," but the sublease is made in a "tenant market." For the preceding reasons and others, sublease rent is usually lower than the rent in the prime lease.

Having considered standards 5, 6, and 7 as a group, let's now review them individually. Standard 5 states that the tenant cannot transfer to a tenant in the building. This is very harmful to the tenant. Tenants tend to speak with one another, and the tenant seeking to transfer its space may be aware that another tenant needs space. Other tenants in the building are, in fact, the most likely prospects for a sublease or assignment. Further, standard 5 does not have an exception for other tenants in the building that have needs which cannot be satisfied by the landlord's available space on the property. For example, the prospective subtenant may be the adjoining tenant,

but the landlord's other space is on a disconnected floor. Also, the prospect may need a larger space than is available or even a smaller space where the landlord does not want to divide the available area. The prospective subtenant may even want to share facilities with the tenant, such as conference rooms, a kitchen, or a receptionist, and the landlord probably does not have those shared facilities available elsewhere. Such carve-outs are often negotiable, but it is very difficult to get the landlord to delete the standard entirely.

Standard 6 is troublesome for many of the same reasons as standard 5. The fact that the landlord is negotiating with the prospect does not mean that the landlord can accommodate the prospect's needs. Also, if the negotiations have ended, why should the landlord continue to have any claim on that prospective tenant? Certainly, the lower rent in the sublease may entice a prospect away from the landlord, but again consider the disadvantages of a sublease as compared with a direct lease, as discussed above. Finally, if the prospect cannot sublease the tenant's premises, which it may prefer to do, then it is very likely the prospect will not want to deal with the landlord, either, but will find sublease space in another building.

Standard 7 defies logic. First, the tenant may well be required, under this provision, to charge more rent to the subtenant than it is paying under its own lease. Second, rent chargeable under a sublease will, in all probability, be less than the rent chargeable under a direct lease. Instead of inserting standard 7 in the lease, the landlord may just as well state that consent may be withheld arbitrarily. Providing that the tenant should not publicly advertise the lower rent may be justified, but it should not prevent the tenant or its broker from quoting the sublease rent to prospects or from leasing for a lesser amount.

Limitation of Remedies

Assume that the tenant has the ideal transferee and has met all of the standards that were not negotiated out of the lease at the time of its inception. The landlord should consent, but what if the landlord denies consent? What does the tenant do?

First, the tenant should look at the lease to see if there are any limitations of remedies; and lo and behold, the tenant may find that the remedy is limited to declaratory judgment or a suit for an injunction. If the tenant lawyer files such an action, how quickly can the issue be decided? How long will the transferee be willing to wait for the suit's outcome? Many leases use such limitations to prevent the tenant from recovering damages for the landlord's default in unreasonably withholding consent. Because of the limitations, however, the tenant does not actually have any effective remedy at all. Moreover, in the author's experience, most landlords are unwilling to modify the limitation of remedies section. What is the tenant to do? Frankly, as a result of the limitations on remedies, all of the discussion of standards in this article may be superfluous unless the tenant in a particular case has substantial bargaining power. Perhaps the landlord may argue for an expedited procedure, and perhaps not.

Landlords impede tenants' realization of the benefits of subleases or assignments in other ways. They may recapture the space by terminating the lease for premises that are subject to the proposed transfer, or they may take or share the profit, if any, of the tenant's deal, or they may prohibit the exercise of options by anyone other than the original tenant. See Sidney G. Saltz, *Landlord Impediments to Subleasing and Assignment: Recapture, Profit-Sharing, and Restrictions on the Exercise of Options*, Prob. & Prop., May/June 2007, at 42.

Conclusion

Lawyers representing tenants should understand that some of the provisions discussed in this article are reasonable protections for landlords but that others are onerous and could seriously impede tenants' ability to respond to changes in its business situation. Those lawyers should seek to negotiate changes in leases to protect their clients' rights while not impinging on landlords' legitimate concerns. Conversely, lawyers representing landlords should not include objectionable provisions in their leases without advising their clients, not only of the unfairness of the objectionable provisions, but also that the inclusion of those provisions may generate extensive (and expensive) negotiations. The fact that other lawyers have inserted such provisions in their lease forms does not justify including them without full discussion with the client. Lawyers should avoid the "lemming effect" of thoughtlessly adding concepts and language to forms just because others have done so. Hopefully, lawyers who have included such objectionable provisions will be receptive to the arguments of tenants' counsel when negotiating leases and will make (or recommend to their clients to agree to) appropriate changes in the leases.

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Landlords attend meetings or read publications that suggest ways to "protect" lessors in assignment and subleasing situations. There may be very little a lawyer representing a landlord can do to convince the client that including difficult conditions in the landlord's consent to a sublease or assignment may constitute overreaching or that denying the tenant an effective remedy for the landlord's default may be unfair. The ultimate decision is, after all, not the lawyer's. But landlord lawyers should understand the effects of their drafting and how it may not be consistent with fairness or good landlord-tenant relationships. ■