



Landlord Impediments to Subleasing and Assignment

*Recapture, Profit Sharing,
and Restrictions
on the Exercise of Options*

By Sidney G. Saltz

Landlords frequently frustrate tenants' proposed assignments and subleases by permitting such transfers only with the landlord's consent. Tenants who surmount the consent hurdle are often confronted with three additional hurdles contained in their leases—the landlord's right to terminate the lease or to exclude the portion of the premises proposed to be transferred (usually referred to as the right to recapture), the right to "profits" that the tenant is to derive from the transfer, and the prohibition on the exercise of options if the tenant itself is not in occupancy of all or substantially all of the premises.

The stated rationale for the inclusion of the landlord's rights under these

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provisions is that the landlord, not the tenant, is in the real estate business and that the tenant should not have the right to make a profit on the landlord's risk dollars. The real reason is that if there is a buck to be made off the property, the landlord wants to make it.

A Little History

When a tenant enters into a lease, it obtains not merely the use and occupancy of the premises; it also obtains an interest in the property—a leasehold estate. Historically, the interest was freely transferable and the tenant was entitled to all the benefits, including the right to any profits that could be made from transferring all or a part of its estate.

In the 1960s, the following scenario frequently applied to the leasing of property—especially new single-tenant buildings. The landlord would obtain a construction loan, build a building on speculation or as a build-to-suit, lease it for 20 years on an absolute net basis, and finance it with a loan that was fully amortized over the term of the lease. The loan amount was based on the anticipated cash flow, and, if the tenant was a credit tenant, the landlord could finance the building for more than its cost. The loans were totally nonrecourse, that is, there were no carveouts. Those leases frequently contained options to extend at rents below the rent during the initial term. Why? Because inflation was not a factor then, and the portion of the rent that was to service the debt was no longer required after the debt was retired so that the landlord then owned the building free and clear.

Thus, some leases were for 20 years at a net rent of \$2.50 per square foot, with two 10-year renewal options at \$2 per square foot. Of course, all the options were exercised, and those leases are just now ending. If the tenant no longer needed the space, it assigned its leases for a substantial consideration or subleased the space at a substantial profit. Landlords determined that this situation should never occur again, and their determination cannot be attributed just to greed. The fact is they did not accurately predict the future. So

they changed their lease forms to protect against what had already happened.

Could such a scenario happen again, to make the hurdles now built into leases really relevant today? Possibly, but probably not. For one thing, lease terms are shorter now. Second, even if leases are long-term (such as ground leases) or contain options to extend, the rents are subject to increase, by being pegged to some index measuring inflation, being measured against the "market," or including some pre-set percentage or dollar increase. As a result, if leases are transferred, it is generally for less rather than more than the rent stated in the lease because subleases and assignments are usually less favorable to the transferee than a direct lease with the owner of the building. Not all landlords who insert protective hurdles into their leases know the history described above, but they still perceive benefits from them.

Let us now examine those additional hurdles in some detail.

Recapture

If a lease permits the landlord to terminate the lease in the event the tenant proposes to assign the lease or sublet the premises, that provision can offer a substantial benefit to each party. The tenant is relieved of its future performance obligations, and the landlord can put the premises to better use. If the tenant has outgrown its space, or needs to move to smaller space and offers the space for assignment or sublease, it will, very likely, have to take a loss.

On the other hand, why would the landlord want to recapture the premises? The landlord may have several reasons. It is possible, although not likely, that the tenant is making a profit on the deal as would occur in one of the very long-term leases described above. Even if no profit is being made on the transfer, however, the landlord may wish to terminate to make a direct lease with the prospective transferee, for more rent or for a longer term.

Perhaps the landlord may wish to recapture for other reasons. It may have another, better tenant who wants

the space; the adjoining tenant may want to expand (and extend its lease); the tenant may be paying below-market rent and the landlord believes that it could lease the space for more money; or the landlord may see the handwriting on the wall for the tenant and thinks that it will, before long, have to terminate the lease (and the sublease) and bring an eviction action. These conditions are impossible to predict when the lease is being negotiated.

There are situations in which the right of recapture may be very disadvantageous for the tenant. Consider, for example, the situation in which the right of recapture may be exercised if the tenant seeks to transfer only a portion of its premises. The tenant may desire to do so because it has leased more space than it needs at the inception of the lease, but intends to grow into the extra space—in other words, it is warehousing the space. It may want the right to sublease the extra space until it needs it. The landlord's right to recapture, that is, to exclude from the leased premises the space proposed to be sublet, would not be in accordance with the tenant's intent and needs.

Then again, the tenant may wish to sublease part of the space to a company whose use is symbiotic with the tenant's. For example, an ophthalmologist may wish to sublease to a contact lens retailer. In each of these situations, the exercise of the right of recapture would be detrimental to the tenant's business.

A more serious problem, so far as the tenant is concerned, may arise if the tenant has a buyer for its business. The right of the landlord to terminate the lease, or even one of the tenant's many leases, may actually prevent the sale. It is generally not in the landlord's interest to interfere with such a transaction, but if the tenant is selling to a highly leveraged buyer and intends to distribute proceeds of the sale to its investors and retire to Florida, the landlord may not really have any recourse if the assignee defaults. Perhaps that situation can be avoided in the consent-to-assignment stage, but there is always the question of reasonableness to consider.

If the landlord recaptures a portion

of the space, how are the attendant costs to be divided? The tenant may have hired a broker or spent money advertising the space for sublease. Inevitably, there will be costs to divide the space by erecting demising walls and separating utilities. New entrances or truck docks may have to be erected. The transferee may reimburse the tenant for a portion of the tenant's cost to build out the portion of the premises being recaptured. The tenant may wish to recover those costs from the landlord. Finally, the parties will have to determine how the rent is to be adjust-



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ed after the recapture. A simple pro rata adjustment of base rent and pass-throughs may not be appropriate, especially if some of the space is back office or storage space. The parties will have to deal with these issues, but it is extremely difficult to do so in connection with the initial lease negotiation because it is impossible to anticipate the circumstances in which the right of recapture may be exercised. During the initial negotiations for a lease, the likelihood of a recapture is very remote.

Sharing the Profit

Many leases provide that if the tenant assigns or sublets at a profit, all or a portion of the profit is to be paid to the landlord. The provision is often drafted in terms of the tenant's paying the landlord the difference between the

rent or other consideration paid by the transferee to the tenant and the amount payable by the tenant to the landlord. It is incomprehensible why a landlord would provide for a sharing of all the excess. Why would a landlord consider it advantageous to create a disincentive to the tenant to negotiate for any excess? Sharing the profit with the tenant makes more sense for both parties.

Still, the parties have serious issues to resolve. What is the consideration for the transfer of the rights under the lease, and what is the consideration for the transfer of other assets? If the tenant is selling its business, is the landlord entitled, under any theory, to share in the consideration for the business itself? Certainly not. What about the sale of personal property? If personal property is involved, how is it to be valued? The tenant may try to overstate the value of personal property to reduce its payments to the landlord. The tenant may want to recover the unamortized cost of its leasehold improvements, but how are they to be valued? Again, profit sharing does not frequently arise, but some attention must be paid to these issues in negotiating the lease.

Prohibition on Transferring Option Rights

Most leases that contain options to extend provide that the option may be exercised only by the original tenant and that tenant must be in possession of the premises at the time of the exercise. Ostensibly, this provision is to prevent a tenant from passing on very favorable option terms to another party by cutting off the option if the lease is assigned or the space is sublet. There are, however, other reasons why the landlord may wish to prevent a third party from exercising the option.

First, there is the question of whether the assignor remains liable under the lease during the extended term. The lease that results from the exercise of the option is, after all, a new contract. Whether the liability continues would have to be researched in any jurisdiction where the issue arose. Or the landlord would have to expressly provide in the lease that the liability

continues. Because the tenant would like to avoid continuing liability, the parties should resolve that issue during the negotiations.

The most important reason why landlords do not want assignees to exercise options to extend, or to have tenants exercise options on behalf of a subtenant, is that they do not really want to grant options in the first place. Options are, as lawyers are fond of saying, "one-way streets." Landlords are bound by their terms, but tenants are not. Even if the rent during the extension is to be at "market" and there is some mechanism for determining market, a landlord would still prefer to have input on the terms of the lease and either to reject the assignee or subtenant as a tenant or to negotiate the terms on its own.

From the tenant's point of view, the right to assign the option right or exercise the right on behalf of a subtenant can be quite important. How easy is it to find a party willing to accept the assignment, or even sublease the space, if the remaining term is short and the right to continue in the space is subject to the landlord's agreement? Of course, the transferee is no worse off than if there were no option, but there is an option in existence. If that option cannot be exercised, however, both the original tenant and the transferee are frustrated.

Conclusion

Obviously, none of the hurdles described in this article is favorable to the tenant. The hurdles are not going away, however, and tenants need considerable economic prowess to get them deleted. The better course for the "average" tenant is to try to negotiate limitations on the powers of the landlord. Because the situations described in this article, like many of the matters dealt with in leases, are relatively unlikely to occur, most tenants will focus on what they perceive may really injure them if those events occur. For this reason, they will not seek to cover every possible contingency. That strategy may be a good one for negotiation, but it is not a very good one if the unexpected does happen. ■