

How to Avoid 13 Dangerous Potholes When Becoming an Office Subtenant

BY WILL GARY, MBA, MIM
METRO DENVER / BOULDER MARKET

If you're considering becoming an Office Subtenant, it's critical to look deeper than the discounted rental rates and free office furniture. Watch out for thirteen (13) dangerous potholes that could cause a big wreck.

The devil is always in the details when you're leasing commercial space, so a savvy Subtenant (or Assignee) should look under the hood at Sublease or Assignment opportunities. As a 100% Tenant Representative in Metro Denver / Boulder with thirty years' CRE experience, I have developed thirteen rules that you and your real estate attorney should consider carefully before you sign a Sublease or Assignment Agreement for your company, professional firm, medical practice, non-profit organization or government agency. In this blog article, I'll refer mostly to Subleases but you should assume that the same counsel pretty much applies to Lease Assignments, too.

Rule #1 - Determine the Sublandlord's Financial Stability

The first critical step for a Subtenant is to perform proper due diligence on the Sublandlord. Make a concerted effort to determine the Sublandlord's financial stability and staying power. Absent those, a Sublease Agreement might not be worth the paper on which it's printed.

If the Sublandlord is a privately held entity, it may even be necessary for the Subtenant to request and review the Sublandlord's financial statements. As a potential Subtenant, you also need to be prepared to present your own entity's financial statements to both the Sublandlord and Master Landlord early in the process, the sooner the better.

If the Tenant / Sublandlord cannot afford to pay its full rent to the Master Landlord, then your hot Sublease opportunity would likely be short lived. To make matters worse, an unfortunate Subtenant in such a situation might receive notice from the Master Landlord either to pay full market rental rates for the space or to vacate the building with only thirty (30) days' notice.

Rule #2 - Seek to Prevent a Buy-out of the Master Lease by the Sublandlord

This is a big "Gotcha" because it's at the foundation of a Sublease. The Subtenant should not allow a Termination or Cancellation of the Master Lease, including via a future Lease Buy-out between the Sublandlord and Master Landlord, since it would also terminate the Sublease. (There goes your hot Sublease deal, drifting upwards in a haze of smoke.) In the Sublease Agreement, the Subtenant should specifically ask the Sublandlord to agree to forego a Lease Buy-out / Termination / Cancellation with the Master Landlord, unless the Subtenant would first approve it in writing.

A Subtenant needs to find out as soon as possible if a Lease Buy-out is the Sublandlord's real intention. If it is, then you might be wasting valuable time fooling with this space at all. On the other hand, if you are ultimately looking for a "subsidized" Direct Lease with a Landlord, then a Sublease opportunity that leads to a Lease Buy-out for the Tenant / Sublandlord just might

be your cup of tea. Why? Because the Landlord's cash settlement from the Lease Buy-out might allow the Landlord to subsidize your new Direct Lease in some manner, say, with some free rent, moving allowance and/or a higher tenant improvement allowance.

Rule #3 - Don't Agree to Everything in the Master Lease

As a prospective Subtenant, you can't change the Tenant / Sublandlord's Master Lease. But you don't necessarily have to agree to everything contained in the Master Lease. It's OK to leave certain obligations in the Master Lease to the Sublandlord and not to accept them as the Subtenant. However, in the Sublease Agreement, you'll specifically have to negotiate to exempt the Subtenant from any unacceptable provisions of the Master Lease and essentially make them not applicable to you.

Rule #4 – Don't Agree to Restore Tenant Improvements to "Original Condition"

Be very careful as the Subtenant not to agree to restore the Sublandlord's original Tenant Improvements ("TIs") back to their "original condition," which means before your Sublandlord signed its Master Lease. Most Subleases occur on an "as-is, where-is" basis, so it could be incredibly expensive for a Subtenant to get to the end of its Sublease Term only to find out that it's responsible for the costs to "restore the Premises to its original condition." That obligation, if it applies, should remain with the Tenant / Sublandlord, not with you as the Subtenant.

Rule #5 – "License" Use of Existing IT Network Cabling

When Tenants move out of leased Office spaces, many Office Landlords now require that they remove all IT Network Cabling installed above the ceiling, so that it doesn't cause a fire hazard or a "spaghetti factory" that will later have to be demolished at the Landlord's expense. Consequently, if a Subtenant is going to re-use a Sublandlord's IT Cabling in the Sublease Premises, the Subtenant should not agree to a "transfer of ownership" or "sale" of the IT Cabling. Instead, the Subtenant should negotiate a simple "License" to use the cabling during the Sublease Term. Otherwise, the

Subtenant might get stuck with the bill to remove all IT Cabling at the end of its Sublease Term.

Rule #6 – Don't Agree to All of a Master Landlord's Remedies for Defaults

The Sublandlord's Master Lease typically has a section about "Landlord's Remedies in the Event of Default by Tenant." Read the Landlord's Remedies with a very critical eye. As the Subtenant, understand that you don't have to carte blanche grant the Sublandlord exactly the same remedies in your Sublease. You might need to carve out or exempt the Subtenant from certain Landlord's Remedies noted in the Master Lease. Leave such remedies only in effect between the Master Landlord and the Tenant / Sublandlord.

For example, the Subtenant should not be exposed to paying the Master Landlord back for the cost of any unamortized Tenant Improvements that were originally built-out for the Tenant / Sublandlord. The same goes for avoiding the Subtenant's exposure to payback of the Tenant / Sublandlord's free rent, moving allowance and any other concessions that could become part of the Landlord's Remedies due to a Default of the Master Lease. These remedies could add up to big bucks and the Subtenant really shouldn't suffer exposure to them.

Rule #7 – Negotiate Right to Remain in the Sublease Premises

In the Master Landlord's Consent to the Sublease, which is almost always required by the Master Lease, the Subtenant should try to negotiate a right to remain in the Sublease Premises if the Master Lease might be terminated or cancelled during the Sublease Term, say, due to an uncured default by your Sublandlord.

Of course, the question immediately arises, what would the Subtenant's rental rates be if the Master Lease were terminated? There could be several solutions, including simply the same rates as noted in the Sublease Agreement or perhaps new ones negotiated at the "Then Fair Market Rental Rates" at the time of the termination. However, in the case of negotiated rates, it's advisable for the Subtenant to get them paired with the "Baseball Method of Arbitration," just in case the Subtenant and the Master

Landlord cannot reach an accord on the Then Fair Market Rental Rates.”

Under the Baseball Method of Arbitration, it would become a “winner takes all” situation because an Arbitrator(s) would select either the Master Landlord or the Subtenant’s proposed rental rates, typically without any averaging of the parties’ proposed rental rates.

Rule #8 – Seek Rights to Sub-sublease the Space

For the Subtenant’s future flexibility, you should also attempt to negotiate rights to re-sublease or re-assign the Sublease Premises (including a portion of it) to a successor Subtenant(s) or Assignee(s). If you can win this provision, which might not be possible in many situations, then you’ll likely still have to obtain the written consent of the Sublandlord and probably the Master Landlord, too. If so, then you or your real estate attorney should seek to cause such consent in the Sublease Agreement and the Master Landlord’s Consent to Sublease “not to be unreasonably withheld, delayed or conditioned” by the other party.

Five (5) business days would be a short timeframe within which to obtain approval from each of the Sublandlord and Master Landlord; ten (10) business days in total. But it’s a good idea to specify in the Sublease Agreement the time to be allowed. Otherwise, too much time could kill your pending deal with a Sub-subtenant.

Rule #8 might be difficult to win in a Sublease Agreement, so normally I would not recommend making it a mandatory or “deal breaker” issue.

Rule #9 – Try to Retain Sublandlord’s Rights to Renew & Expand

To be fully forthcoming, we have never have tried too hard to follow this rule due to the very low likelihood of achieving success. Nevertheless, could a very creditworthy, attractive Subtenant get the Master Landlord to agree not to extinguish the Tenant / Sublandlord’s Rights to Renew and Rights to Expand? Almost all of the time, both of these rights in the Master Lease go away when a Sublease or Assignment occurs. If the Subtenant or Assignee is a bigger, more creditworthy entity

than the Tenant / Sublandlord, then a Master Landlord just might waive its rights in the Master Lease to eliminate the Sublandlord or Assignor’s Rights to Renewals and Expansions.

Rule #10 – Remove Future Conflict over Tenant Improvements

Technical though it may be, this rule could potentially come into play. Let’s say that the Sublease and Master Lease both expire but the Subtenant wants to remain in the Sublease Premises and sign a new Direct Lease with the Master Landlord. What happens to the existing Tenant Improvements, which the Subtenant wants to keep in place, if the Tenant / Sublandlord is required under its Master Lease to restore the Premises to “original condition” upon expiration of the Master Lease?

Obviously, the Sublease Agreement and/or the Landlord’s Consent to Sublease need to address this possibility upfront in writing and you as the Subtenant should not wait until expiration of the Master Lease to attempt to unravel the conflict in your favor. It could be an expensive pothole waiting down the road and you should repair it upfront.

Rule #11 – Get Rights to Cure Sublandlord’s Defaults

The Subtenant should seek to obtain Rights to Cure Defaults of the Master Lease by the Tenant / Sublandlord, which also requires that the Subtenant would receive a timely written Notice from the Master Landlord of any Default by the Tenant / Sublandlord. This, however, does not deal with an important aspect of curing a Sublandlord’s Default of the Master Lease, which is how would the Subtenant get repaid by the Tenant / Sublandlord for curing such a Default? Consequently, the Notice provision also needs to be paired with a reimbursement provision to make the Subtenant whole.

Rule #12 – Attempt to Win Right to Self Help if Sublandlord Defaults

As part of Rule #11, the Subtenant should also seek the Right of Self Help as part of its Rights to Cure. This would allow the Subtenant to perform any necessary remedial or repair work and then deduct from its Sublease Rent in order to get reimbursed by the Sublandlord for the

Subtenant's reasonable expenses. However, I note that getting a Right of Self Help is not easy or common, although in principle, it should be easier for a Subtenant to achieve than for a Direct Tenant dealing with a Landlord. Rather than being able to deduct from its Sublease Rent, a Subtenant might have to negotiate a different process for getting reimbursed by the Sublandlord for curing the Sublandlord's Default of the Master Lease.

Rule #13 – Negotiate Higher Liability Limit on Sublandlord's Indemnification

To see what the Subtenant's recourse would be in the event of a Default of the Master Lease by the Tenant / Sublandlord, the Subtenant should look carefully at the "Indemnification Provision" in the Master Lease. Typically, a Master Lease would limit the Master Landlord's liability exposure to the Master Landlord's "interest in the Property." Essentially, this means the Master Landlord's equity value in the Property, which could potentially be very low if the Property had recently been refinanced.

Consequently, if this same provision would pass-through the Sublease Agreement to the Subtenant, it would also apply to the Subtenant in the event of a Default by the Sublandlord. If so, then Subtenant's financial recourse against its Sublandlord would be limited to the "Sublandlord's interest in the Property." Unfortunately, the value of the Sublandlord's interest would only be the Sublandlord's Master

Lease, which would be worth almost nothing. Therefore, the Subtenant should seek to negotiate a higher liability limit from the Sublandlord in the Sublease Agreement.

SUMMARY & CONCLUSION

These rules are not simple or easy for a Subtenant to follow when negotiating a Sublease Agreement or Assignment of Lease. It's a huge help to have an experienced real estate attorney on your side, along with a savvy 100% Tenant Representative. Some of these points / rules could be brought up initially in the Subtenant's letter of intent ("LOI") or letter of understanding ("LOU"). However, many of them are going to have to wait until you and your advisors can get your hands on the Master Lease and the proposed Sublease Agreement.

You can try to fill in the thirteen dangerous potholes yourself. But you're likely to come out far better if you have an experienced road crew of professionals in the back of your truck.

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