

Assignment and Subletting Clauses in Office Leases: A Critical Exit Strategy

BY AMOL PACHNANDA

Entering into a long-term lease is a major commitment for any landlord and tenant. And, to a certain degree, it is a gamble. The tenant is taking a calculated risk that the space will meet its needs during the entire length of the lease term.

In many instances, the tenant will find that it has outgrown the space or that it has more space than it needs. As part of its real estate strategy, the tenant must attempt to anticipate growth in its business by negotiating any or all of the following options: expansion option(s), right of first offer, and/or right of first refusal. The tenant should also attempt to anticipate a decline in its business by negotiating a contraction option and/or an early termination option. Unfortunately, many start-ups and small companies lack the necessary muscle to negotiate a contraction option or an early termination option in their lease—the types of provisions that would seem to be most beneficial to such a tenant. However, a contraction option and an early termination option are not the only two routes available to the tenant that has planned for an exit strategy as part of its overall business plan. By carefully negotiating the assignment and subletting clause in its lease, the tenant has an exit strategy



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that will permit the tenant to mitigate its losses when the space no longer fulfills its needs.¹

So, if the assignment and subletting clause in a lease is so important, why is it that many tenants and their lawyers simply gloss over the entire clause? I have been on the opposite side of lease negotiations where the tenant's attorney, save for inserting the word "reasonable" in a few places, will accept the landlord's restrictive and burdensome assignment and subletting clause in its entirety. One reason may be that the tenant's business person tasked with negotiating the lease is more focused on distilling the lease down to numbers that can be easily explained to the board and to others who are ultimately responsible

for the making the final decisions. When this business person is asked to make a decision on an issue, he or she may instinctively ask, "How much will this cost me?" If the lease provides for a 5 percent penalty for late payment of rent, the cost is obvious. On the other hand, a good assignment and subletting clause is hard to quantify. A poorly negotiated assignment and subletting clause is even harder to quantify because when the tenant eventually needs the landlord's consent to a lease assignment as part of a larger corporate transfer, it is anyone's guess as to how much it will cost to get the landlord's consent. At that point, the tenant is not negotiating from a position of strength.

What follows is a discussion high-

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lighting the various ways that landlords try to hinder the tenant's ability to assign the lease or sublet all or a portion of the space, and the various ways that the tenants can push back against the landlords when the landlord is overreaching.

Standard for Landlord's Consent.

When deciding whether or not to approve an assignment or sublease, most landlords will insist in the lease that they must have sole and absolute discretion. A red flag should go up if the landlord refuses to act reasonably under the lease with respect to any provision (excepting circumstances where the tenant's alterations affect the structure of the building or building systems, where the sole and absolute standard is more understandable). Is this the type of landlord that the tenant wants to enter into a long-term relationship with for lease of office space? No landlord will come out and readily admit to the tenant that, yes, he or she is unreasonable. To avoid such a result, landlords will generally agree to add a new paragraph which provides that, under certain circumstances, the landlord will act reasonably in giving or denying its consent to an assignment or sublease. A discussion of the types of acceptable circumstances appears later in this article.

Landlord's Time to Respond to Tenant's Request. Typically, the assignment and subletting provision in the landlord's standard lease form does not provide that the landlord will give or deny its consent within a definite period of time. The tenant should insist that the landlord must give or deny its consent within a certain number of days after the receipt of the tenant's request. If the landlord fails to respond within the agreed-upon time period, then the landlord should be deemed to have consented to the proposed assignment or subletting. Nothing will kill a prospective sublease or assignment faster than silence from the landlord. If the landlord declines to accept "deemed consent" language, the tenant can agree to provide a second notice that clearly states in bold capital letters that the landlord's failure to respond within 5 or 10 days

following the receipt of the second notice will be deemed to be the landlord's consent to the proposed assignment or subletting. Now the landlord may deny its consent, but at least the tenant has a response and can go back out to the market and look for a new assignee or subtenant. Many tenants will informally contact the landlord to gauge whether or not the landlord is likely to give or deny its consent to assignment or subletting in question. By keeping the landlord constantly informed, the tenant increases its chances of getting the landlord's approval, and, as important, getting that approval quickly.

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Landlord's Recapture Option. Many leases will provide that if the tenant wants to assign the lease or sublease all or any portion of the space, then the landlord has the right in the case of an assignment to cancel the lease and, in the case of a sublease, to recapture the space proposed to be sublet. At first glance, from the viewpoint of the tenant that is trying to dump either the whole space or a portion of the space, this is the ideal scenario. However, if the tenant fails to carefully negotiate this provision, the tenant may hamstring its future growth. If the tenant has a long-term lease and is temporarily suffering from a slowdown in business as the result of a stagnant economy (and, as a result, has more space that it currently needs), this provision would leave the tenant without the current office space when the economy picks up again. At worst, it can put the tenant out of business as employees and clients go elsewhere.

What the tenant in the above example needs is the right to "warehouse" some space for a short period of time without triggering the landlord's onerous recap-

ture option. The tenant should negotiate that the landlord's recapture option only kicks in if the tenant intends to assign the lease or sublease substantially all of the space for substantially all of the remainder of the lease term (e.g., 90 percent of the space for a term expiring during the last year of the original lease term). This limitation of the landlord's recapture right preserves the tenant's ability to temporarily "warehouse" space and then expand into the "warehoused" space if business conditions improve. In the situation where the tenant intends to assign the lease or sublease substantially all of the space for substantially all of the remainder of the lease term, the tenant does not see the lease as part of its long-term needs and will welcome the opportunity to dispose of the asset.

Keeping the right to warehouse space is not the only way to limit the exercise of the landlord's recapture option. If the tenant is leasing a large block of space in a building, the tenant may consider negotiating the right to freely sublease a portion of the space (for any length of time) without triggering the landlord's recapture option.

Assuming that the tenant was successful in limiting the circumstances under which the landlord's recapture option is triggered, at what point in its negotiations with a prospective assignee or subtenant must the tenant find out whether or not the landlord will exercise its recapture option? As early as possible in the negotiations. There is no point in spending months negotiating a sublease or assignment document with a prospective transferee only to have the landlord exercise its right to recapture the space. In fact, the tenant should not even be forced to spend weeks negotiating a letter of intent before approaching the landlord to inquire whether or not the landlord will exercise the recapture option. As soon as the tenant has decided that it wants to assign the lease or enter into a sublease that triggers the landlord's recapture option, the tenant should have the right to ask the landlord whether or not the landlord will exercise its recapture option.

The one final point to consider when dealing with the landlord's recapture option is that the option should not be triggered in connection with corporate type transactions. If the tenant is selling the business and the lease is part of what is being assigned, the landlord should not have the right to recapture the space. Such a result may put the entire transaction in jeopardy.

When Landlord Must Act Reasonably in Consenting to an Assignment or Subletting. As mentioned above, landlords, as the standard rule, will insist on sole and absolute discretion in deciding whether or not to give their consent to an assignment or sublease. However, tenants should get the landlords to ultimately agree that, so long as the proposed assignee or subtenant meets certain criteria, the landlord will not unreasonably withhold, condition or delay its consent. Although ideally the landlord should have very little involvement in what the tenant does with its space (this is especially true in an office building where a tenant is unlikely to attract customers to the building that will make the building more attractive to other tenants), it is not unreasonable for the parties to agree that the landlord can base its decision on whether or not to consent to a proposed assignment or subletting on certain objective criteria (i.e., criteria that will not change based on who the landlord is at the time of the tenant's request for consent to an assignment or subletting). The landlord should base its decision on the following objective criteria:

A. Financial responsibility of the assignee: Absent a novation, the original tenant is always on the hook for the lease obligations. In the case of an assignment, the original tenant is secondarily liable to the landlord—it is effectively a guarantor of the assignee's obligations. Since the landlord and the assignee are in privity of contract, it is not unreasonable for the landlord to separately consider the creditworthiness of the assignee notwithstanding the fact that the original tenant may continue to be liable under the lease. By contrast, a sublease does not release

the tenant from its liabilities to the landlord. The subtenant does not have privity of estate or privity of contract with the landlord, so it can be argued that the subtenant's financial condition is truly irrelevant. This is especially true if the subtenant does not have a recognition agreement from the landlord. In the absence of a recognition agreement, the landlord does not have to recognize the sublease once the lease is prematurely terminated.

B. The business character of the assignee or subtenant: Landlords of first-class buildings, and their tenants, want similar first-class-type tenants in the building. It is reasonable to expect the landlord to want the right to decide whether or not the proposed transferee will be a good fit with the other tenants in the building.

C. The proposed use does not violate any pre-existing restrictive covenants: An existing lease might provide that the landlord cannot consent to a sublease to a competitor of an existing tenant. In deciding whether or not to give or deny its consent, it is reasonable for the landlord to consider whether consent to the assignment or sublease will put the landlord in default under an existing lease.

D. The nature of the occupancy: It is reasonable for the landlord to consider how the particular nature of the assignee's or subtenant's occupancy will impact building systems.

The tenant should push back against language in the lease that expands the list of objective criteria that may be considered by the landlord.

Certain Transfers Not Subject to the Landlord's Consent. The most important carve-outs from the landlord's consent right are corporate-type transactions. If the tenant gets nothing else, it should negotiate for these carve-outs. It would be a nightmare for a tenant that is selling its business to have the entire sale held up because one landlord has the right to approve or disapprove the lease transfer in connection with the sale. It is immensely important that the tenant negotiate the right to undertake at least the fol-

lowing transfers without the landlord's consent: transfers to affiliates, parent entity, or subsidiaries, or transfers to an entity with which tenant is merged or consolidated or which acquires all or substantially all of the property and assets of the tenant; transactions whereby the tenant becomes a publicly traded company; transfers of stock of a publicly traded company; and the addition, withdrawal or death of partners. In the context of a transfer to a successor by merger or consolidation, landlords will require that the successor have a net worth (insist on net worth that takes into account both tangible and intangible factors) or net income (in the case of service industry tenants), as the case may be, that is at least as favorable as tenant's condition prior to such succession transaction. This is a reasonable request.

Conclusion

It is the author's hope that this article will serve as a quick reference guide when the reader is confronted with analyzing the assignment and subletting clause in the landlord's form lease. The large established tenant may be able to negotiate a contraction option or early termination options in its lease as part of its exit strategy. It is unlikely that a small tenant will have the leverage to negotiate such provisions in its lease, so smaller-sized tenants have to be smarter in how they negotiate their exit strategy. One of the ways to do this is by negotiating the assignment and subletting clause so that it gives the tenant that flexibility to exit the lease if the business does not succeed as planned, or the business grows too rapidly (a good problem to have).

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1. A contraction or an early termination option is far better than simply being able to assign the lease or sublet all or a portion of the space. Such options permit the liability associated with a lease (or a portion of the space in the case of a contraction option) to come off the tenant's books. In contrast, absent a novation, a tenant remains liable following an assignment and sublease.