

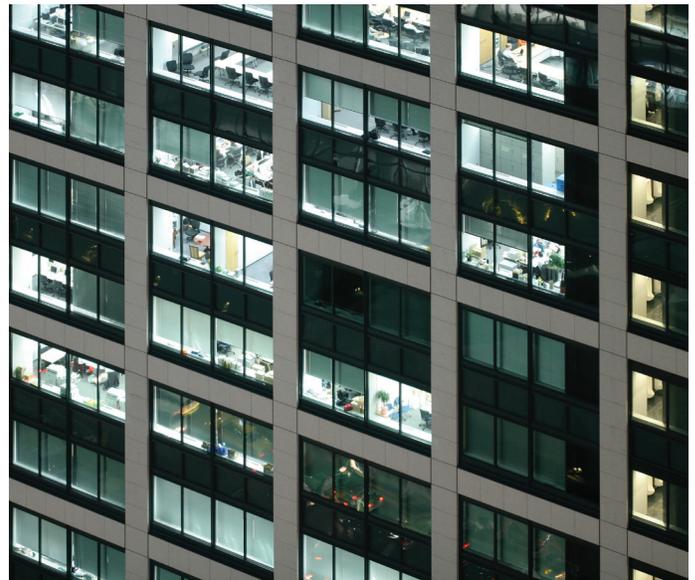
The Art of Subleases— Risks, Tips & Landmines

David Marino | Hughes Marino Blog

As we emerge from the *Shelter in Place* order, many companies will find themselves with excess space or facilities that they no longer need. Certainly, a good portion of the millions of layoffs over the last few months were office and manufacturing workers whereby many companies simply will not need the amount of space that they contracted for in the last couple of years. In addition, many companies are finding that work from home is actually working quite well for certain team members, or certain job functions, which will further reduce corporate America's real estate footprint.

The way companies reduce their footprint is by subleasing their excess space. Already across the United States, year-to-date inventory of sublease space has begun spiking and some markets have jumped materially: 50% in the Los Angeles metro area; 85% in the Inland Empire; 35% in Orange County and 30% in San Francisco. All other U.S. metro areas are showing year-to-date increases from 10% to 20% and are trending behind California. Whether California's economy got hit faster and harder because of California's leading shelter in place move, and the rest of the U.S. will soon follow, is too early to tell.

As we come out of this crisis and get back to work, tenants with expiring leases looking for value will be particularly interested in sublease opportunities as subleases can always be had below market, typically for a shorter-term than landlords are often willing to consider, and frequently come "plug and play"—fully furnished and fixtured. Whether you are a sublessor, the party wanting out of the space, or a



sublessee considering getting into a sublease, there are a lot of mistakes, pitfalls and misunderstandings that the parties will want to avoid when going through the sublease process.

Recommendations for the Sublessor

Pricing Strategy

The most important part of successful subleasing strategy is to price it to move it. That means being in the bottom quartile of asking prices, and at least 20% below the landlord's asking price for comparable space. Average time on the market is going to increase from 6 to 9 months in most product types and submarkets in 2019, to 12 to 18 months by the end of 2020. If you want to get rid of the space, pricing it attractively matters—do not price as "negotiable" or "undisclosed." You want to show motivation and you need a "cup half-full" mindset—rather than how much you lose, focus on how much you can recover. If



you miss the first sublease opportunity, the second real prospective sublessee might not come along for another three or four months thereafter, so closing fast is everything.

Credit, Business and Use

Make sure to get business information about the prospective sublessee including a prior landlord reference, an understanding as to how they operate, their general business reputation and financials. As sublessor, you are now taking on much of the risk that a landlord typically incurs, particularly as it relates to rent payment. If you sign a sublease for three years, you can't have your sublessee default in the middle of the term as it will be very difficult to further re-sublease space that has less than 18 months of remaining term. Common solutions to enhance credit are to get the sublessee to post more pre-paid rent than the standard first month, such as pre-paying additional rent for months 12, 18 and 24. Alternatively, negotiate for the sublessee to post a couple of months security deposit instead of the standard last month, and if they can't or won't, that might be a red flag. Stay away from personal guarantees as they are simply too hard to enforce.

Recommendations for the Sublessee

Sublessor Default

The biggest risk for the sublessee is that your sublessor runs into further business troubles during the term and defaults

on the lease itself, which is often referred to as the "master lease." When default of the master lease occurs and the master lease terminates, the sublease also gets wiped out. You might imagine the immediate distress this would put on a sublessee, as not only does the beneficial below market rent go away, but the sublessee no longer has any lawful rights to the premises. Smart lawyers and advisers will tell you that in order to protect against such risks, you should obtain a "non-disturbance and attornment agreement" from the landlord that would obligate the landlord to honor the sublease terms if this occurred.

However, this is unlikely to happen as a landlord is never going to obligate itself to honor a sublease where the rent payment is less than the master lease itself, or whereby only a portion of the premises has been subleased. While practically most landlords are going to rush into the chaos and try to get the sublessee to enter into a new lease if their tenant defaults, those terms are not likely to be as beneficial as you were paying before. The good news is that you probably won't lose the space, but you will almost certainly lose the sweet deal that you negotiated.

Security Deposits and Furniture

A sublessor default stings in other ways as well. Your cash security deposit may be gone for good if your sublessor defaults. In order to avoid this, you should always post a sublease security deposit as a letter of credit and not cash. And the furniture that you bargained for as part of



the sublease? If you didn't create a bill of sale and take ownership of the furniture when you signed the sublease, you might be getting a call from a bankruptcy trustee intending to take and sell all of that furniture and equipment that came with the sublease.

What Your Lease Terms Really Mean

Recapture Rights

Tenants often misunderstand some of the terms and conditions outlined in their lease. One concept that is often misunderstood is the landlord's right to "recapture" the premises in the event that a tenant seeks to sublease the space. There are several reasons a landlord might prefer to take the space back, or "recapture" the space, rather than consenting to the sublease. For example, the landlord may want the space for another tenant in the building looking to expand. This provision simply gives the landlord the opportunity to take the space back instead of approving the sublease. Too often, tenants misconstrue recapture as some kind of darker scheme for the landlord to disrupt the subleasing process, but it simply exists for landlords to accommodate other growing customers. For the sublessor, if the space is recaptured, you are relieved of the lease obligation, which was the original objective anyway.

Landlord Consent

Tenants often misunderstand the process whereby landlords give consent. It is not unreasonable for landlords to seek the same information about the sublessee that you should be concerned about yourself. This includes operating history, financials, intended use of the space, business reputation

and a reference check from the prior landlord. Be proactive in gathering this information and presenting it to the landlord to expedite the consent. Also understand that the consent document itself is a separate, multi-page agreement that requires execution by the sublessor, sublessee and ultimately the landlord, and the transaction is not complete until the consent is fully executed. This process can take a few weeks, so make sure to start early and be prepared for that time lag.

Assignment

An assignment provision is intended for circumstances where the tenant is sold through a merger, transfer of a majority of the stock or other transaction, whereby there is an affiliated successor to the actual tenant. In those cases, the lease assigns to the successor of the tenant as the landlord essentially has the same company operating in the space, but simply with new ownership or a new parent company, often with the credit of the tenant improved through such a merger. When the space is transferring to a third party on terms different from the master lease, the landlord is not going to recognize your sublessee as an assignee.

There are a myriad of risks and landmines when it comes to subleasing space. With proper counsel and documentation, most can be easily avoided. We have artfully completed hundreds of subleases over our history of representing tenants and we are here to guide our clients and friends through the minefield to make sure they are structured and documented to reduce risks for all parties. □

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