

real estate

SOUTHERN CALIFORNIA

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THE SUBTLETIES OF SUBLEASE DEALS

WHAT'S OBVIOUS ABOUT sublease space is that it rents at a discount—sometimes up to 50%—and that an abundance of it drives down rates for direct space. Beyond that, however, the sublease realm is filled with subtle variations on the landlord-tenant relationship, including some pitfalls and disadvantages for both sides, legal and otherwise.

Attorney Susan McNally of Gilchrist & Rutter in Santa Monica outlines some other advantages of sublease space for tenants. It is usually already built out, frequently comes furnished and is ready to move into right away. The downsides, McNally says, are that the space may be available for only a short term, the subtenant may not have the right to renew the term or expand into more space if it grows, and the subtenant can't improve on what the original tenant has already negotiated with the landlord.

But the biggest potential problem with subleases is that the original tenant will go out of business or otherwise default under its lease with the real landlord. The danger is that in the case of a default by the original tenant, who is acting as a sublandlord, the sublease will be null and void. "There are a couple of ways to address this," McNally says. One is to get the master landlord to enter into a recognition agreement with the subtenant. That way, if the original tenant defaults, the building owner will recognize the sublease. "The master landlord is only going to be willing to do this if the sublessee has at least as good credit as the tenant" and is obligated to pay at least as much in rent as the original tenant was paying, McNally says. Another way around the potential problem is for the subtenant to pay the rent directly to the master landlord. This prevents the original tenant from taking the rent paid by the sublease tenant and using it for something other than paying the building owner. Another solution is to get the building owner to agree to notify the subtenant if the original tenant doesn't pay the rent and then allow the subtenant to make good on the rent.

Prospective subtenants are wise to the risks involved in sub-

leasing from a financially weak tenant, according to Greg May, a SVP of leasing with Transwestern Commercial Services in Irvine. "We're seeing sublease space turning to direct space because the tenant is in such a weak financial position and can't find a subtenant," May says. Another of the not-so-obvious

implications of sublease space, May says, is that it can reduce the amount of financing a landlord can qualify for. "The lender will look at sublease space as space that most likely will be vacated on the expiration of the lease," he notes.

One of the trickiest situations occurs when an original tenant goes bankrupt. In this case,

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Susan Fowler McNally

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McNally says, "Much depends on whether the (bankrupt) tenant elects to assume or reject the lease." If the subtenant is paying above-market rent, the bankrupt tenant will probably keep the lease to continue receiving the cash generated by the sublease. But if the bankrupt tenant rejects the lease, which is permitted under bankruptcy law, the sublease will be wiped out unless the subtenant has already obtained a recognition agreement from the master landlord.

If the sublease is terminated the subtenant can always negotiate with the master landlord and offer to lease the space, McNally says, but the landlord will likely insist that the subtenant enter into a long-term lease at the full market rate. ■

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