

Subleasing Heats Up: Critical Issues in Sublease Transactions

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By most accounts, subleasing activity has markedly risen during 2001 in Long Island. Some of the factors for this expanded activity are low vacancy rates for direct space, little new construction (particularly in Nassau County), reduced space needs due to corporate mergers and consolidations, and dot-com and telecom failures and/or cutbacks in planned expansion. Companies looking for new space in 2001 may ultimately enter into a sublease with a tenant rather than a direct lease with the building owner. A number of critical points must be considered in a sublease that is not present in a direct lease transaction.

Subleases generally incorporate all of the terms of the direct, or master, lease, and make them applicable between the sublessor and subtenant as if they were the parties to the master lease. Subtenants must review master leases thoroughly before entering into a sublease, and make sure that the sublease carves out those clauses of the master lease that have no applicability to the particular sublet arrangement (e.g., fixed rent, expiration date, description of demised premises, cure periods, etc.).

In addition to obtaining landlord's initial consent to the sublease, subtenants must also protect against the future termination of the sublease by "operation of law." In other words, if the master lease is terminated due to the sublessor's default under the master lease, the sublease will be contemporaneously cancelled because the subtenant cannot acquire a greater interest to the space than the sublessor had. The best protection for a subtenant against that egregious result is to obtain a non-disturbance agreement from the master landlord.

A non-disturbance agreement allows a subtenant to remain in its space under the terms of its sublease, even if the master lease is terminated. Normally, the master landlord has no incentive to provide this benefit to the subtenant, particularly where (as in many cases) the rent and the term

under the sublease are less than the corresponding provisions of the master lease. A subtenant should expect the landlord to require, at minimum, that the subtenant pay the same rent as required under the direct lease, and post equivalent security, in exchange for non-disturbance protection.

Short of a non-disturbance agreement, a subtenant should negotiate certain protections against the cancellation of the sublease that would result from a default by the sublessor. Subtenants should try to obtain the right, but not the obligation, to cure any default under the master lease, and, in any event, copies of notices of default should be sent to the subtenant.

The sublease should allow the subtenant to pay its sublease rent directly to the landlord, and that the sublandlord should pay only the differential between the master lease rent and the sublease rent. This would protect against the sublessor absconding with all of the rent under the sublease, and never paying the landlord. Even if the landlord pursues a default under the master lease, the landlord as a potential direct tenant may look upon the sublessee more favorably after having paid its sublease rent directly to the landlord.

From the subtenant's standpoint, the landlord's consent to the sublease should include a provision that the landlord will not amend the master lease in a way that may negatively impact the subtenant's position. If the landlord refuses, the sublease, at minimum, should preclude the sublessor from entering into such an amendment of the master lease.

Subtenants should also ensure that they have meaningful remedies if services are not provided to the space. Under the master lease, the landlord generally must provide utilities and essential services. However, sublessors are not building owners, and they will disclaim responsibility and evade recourse if the services do not reach the subtenant. Unfortunately for subtenants, landlords generally will not agree to be liable directly to subtenants for failure to provide or maintain services. Consequently, a subtenant must require that the sublessor (within fixed time periods) demand that the landlord provide the services in question. Failing prompt restoration of services, the subtenant must have the ability to sue the landlord in the sublessor's name, and the sublessor must be required to cooperate with subtenant's efforts.

Given that direct tenants may have pressing needs to sublet, often at rates less than landlords are charging for vacant space in the same building, companies looking to relocate or expand will be presented with financially advantageous subleasing opportunities. To maximize the benefits of those opportunities and to avoid potentially disastrous pitfalls, the issues raised in this article, and others, must be successfully resolved.

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