

## Smart Subtenant Protections: Part 1: Focus on Due Diligence

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This article discusses sublease due diligence from the subtenant's perspective. The author primarily focuses on issues raised by office subleases. Retail and industrial leases often raise the same issues, but other issues may assume greater importance in these transactions or the same issues may be viewed from a different perspective. For example, environmental due diligence and the overlease's environmental provisions commonly assume much greater importance in an industrial sublease than in an office space (a cleaner use). Although assignment and sublease rights are often important for all subtenants, for the proposed subtenant of restaurant space, the primary issue is often the subtenant's ability to sell the restaurant. The retail subtenant will also focus on the use clause, percentage rent, signage rights, parking rights, exclusives, and subdivision and demising rights.

A note about terminology is appropriate. A sublease is a leasing arrangement under which a tenant (the "tenant" or "sublandlord") leasing space directly from a building owner or ground lessor under a direct lease (the "overlease" or "lease," "overlandlord," and "leased premises") either leases a portion or all of the space to a third party for part of the term (the "subtenant," "sublease," and "subleased premises"), in contrast to an assignment, in which the tenant transfers its entire interest in the overlease to a third party.

The distinction between assignments and subleases is not always clear. Reservation by an assignor of some right under the lease (for example, the right to exercise an extension option or a right of reentry) may convert a purported assignment into a sublease, creating confusion over whether the overlandlord can enforce the lease against the purported assignee. Milton R. Friedman & Patrick A. Randolph, *Friedman on Leases* § 7:4.3(A) (5th ed. 2004). Conversely, a purported sublease of the entire leased premises for the entire balance of the term of the overlease will, in most states, be treated as an assignment, creating confusion over who may exercise option rights under the overlease and to whom the overlandlord should look for its remedies. *Id.* § 7:4.3. Nonetheless, according to *Friedman on Leases*, "It is reasonably clear that despite the thicket of ancient concepts there is some judicial effort to construe the relationships, as assignments or subleases, substantially as the parties had intended." *Id.*

The terms “sublessor” (that is, the sublandlord) and “sublessee” (that is, the subtenant) will not be used in this article for the simple reason that the author has yet to see a sublease using that terminology that did not confuse those words in one or more places; stating, for example, that “the Sublessor will pay rent to the Sublessee at the following rates.”

### **Office Sublease Scenario**

The client, who has been looking for suitable space at a good rent for six months, has found beautiful office space in a Class A building at a very inexpensive rent. The space, of course, is being offered for sublease. That is why the rent is low. Subleases are generally “distress” transactions in that the sublandlord is seeking to dispose of space that no longer suits it, and the rent usually reflects the nature of the transaction. The client assumes that the negotiation of the sublease will be a snap because the 100-page overlease has already been fully negotiated, and the sublease, which incorporates the terms of the overlease, is a mere 10 pages. For a very small sublease, the client may be right (or the lawyer may need to find a way to streamline the negotiation to fulfill the client’s expectations). But as all lawyers know, a sublease can be harder to review, evaluate, and negotiate than a direct lease; the incorporation provisions can drive one crazy; and, of course, everyone will be in a hurry.

Subleases come in all shapes and sizes, and the scope of the subtenant’s due diligence and the complexity of the negotiation will be governed by the nature of the sublease. For example, if the subtenant is subleasing a small portion of the leased premises and the sublandlord remains in possession of the balance of the premises, the subtenant will have less concern about whether the sublandlord will actively pursue its remedies under the overlease if the overlandlord fails to provide services or overcharges for operating expenses than if the subtenant is leasing all or substantially all of the leased premises, in which event the subtenant will have much greater concern about whether the absentee sublandlord will be willing to enforce its rights as tenant under the overlease. Also, if the subtenant is subleasing a small space at a bargain basement rent, both parties will have a very low tolerance for extensive due diligence, lengthy negotiations, and substantial legal fees.

### **“The Talk”**

Before starting due diligence, the attorney should have “the talk” with his or her client. Every leasing lawyer knows that subleases carry with them unusual risks. Among other things, if the overlease is terminated for any reason, including the sublandlord’s default, the sublease will fall absent a separate agreement by the overlandlord to recognize the subtenant’s occupancy (more on that below), Friedman & Randolph, *supra*, §§ 7:7.1, 7:7.3; if the sublandlord files for bankruptcy and rejects the overlease, the sublease will fall, 11 U.S.C. § 365(h); and if the overlandlord fails to provide services to the space, such as heat or air conditioning, the subtenant has no direct legal right against the overlandlord because there is no contractual privity between the subtenant and overlandlord. See Friedman & Randolph, *supra*, § 7:7.1. In fact, the overlandlord is not even required, under principles of common law, to accept performance by the subtenant of the sublandlord’s obligations under the overlease (including as to payment of rent). *Id.* § 7:7.4 and note 600. The fact that the attorney understands the risks does not mean that the client does. The risks need to be clearly explained to the client. The termination risk can be mitigated with a recognition agreement (discussed below) under which the subtenant acknowledges the subordination of the sublease to the overlease and agrees to attorn to the overlandlord if the overlease is

terminated (provisions that are usually included in the sublease and overlease as well), and the overlandlord agrees to recognize the subtenant's occupancy rights under the sublease if the overlease is terminated (a "recognition agreement"). That mitigation usually comes at a price (discussed below).

### **Due Diligence—General**

As with any leasing transaction, a certain amount of due diligence should be conducted by the subtenant's attorney. Due diligence for subleasing transactions generally falls into four categories: (1) review of the overlease, (2) confirmation of the status of the overlease through an overlandlord estoppel or the overlandlord's written consent to the sublease (the "overlandlord consent"), (3) the possible effect of legal requirements, and (4) physical plant due diligence. For two excellent articles on subleasing that include discussions of due diligence, see Andrew L. Herz & Russell G. Wohl, *Subleases: The Same Thing as Leases, Only Different*, 35 Real Prop. Prob. & Tr. J. 1 (2000), [https://www.americanbar.org/content/dam/aba/events/real\\_property\\_trust\\_estate/symposia/2010/1983.authcheckdam.pdf](https://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/symposia/2010/1983.authcheckdam.pdf); Brent C. Shaffer, *Sublease Due Diligence*, Prob. & Prop., Sept./Oct. 2003, at 44.

### **Due Diligence—Review of Overlease**

Overlease due diligence involves two simple questions: (1) how does the overlease limit and control the sublandlord's ability to sublease to the subtenant, and, given those limits, can the transaction be effected at all and, if so, within the subtenant's time frame; and (2) do the other terms of the overlease create any major problems for the subtenant's proposed occupancy of the subleased premises?

### **Controls on Sublandlord's Ability to Sublease**

Because the overlandlord wants to exert some control over who occupies his building, virtually all office leases impose some controls on the tenant's ability to sublease. The issue for the subtenant is whether those controls actually prohibit the proposed sublease or will so hamper the transaction that the subtenant will be unable to take occupancy within a reasonable period. Typical overlease "control" provisions include the following.

**Limits on Number of Sublets.** Some overleases limit the number of sublets the tenant can effect. Before committing substantial resources to the sublease negotiation, subtenant's counsel should determine if the overlease contains such a limit and, if it does, should confirm either that the proposed sublease will not exceed the limit or that the overlandlord will waive the requirement for the proposed sublease in the overlandlord consent.

**Overlandlord Consent and Recapture Right.** Does the overlease require overlandlord consent to the sublease, does the overlandlord have the right to recapture the space or terminate the lease, and how long does the overlandlord have to decide whether or not it will recapture and consent? Many leases give the overlandlord a very substantial amount of time to make both decisions. Accordingly, if timing is an issue for the subtenant (for example, the subtenant is at the end of its lease, going into holdover, and likely to incur substantial holdover penalties), the overlandlord should be approached informally before commencement of sublease negotiations to determine whether there are possible obstacles to the sublease transaction and also whether the overlandlord will be willing to make its decision quickly. Many brokers will pre-clear the proposed sublease transaction with the overlandlord as a matter of course so that time isn't wasted negotiating a transaction that is likely to go nowhere.

**Right to Recognition Agreement.** If the transaction is conditioned on the execution and delivery of a recognition agreement, does the overlease require the overlandlord to deliver a recognition agreement? An in-depth discussion follows.

**Required Sublease Provisions.** The lease's assignment/sublet provision may require the sublease to include specific provisions benefitting the overlandlord (such as an obligation to pay sublease rent to the overlandlord if the sublandlord defaults). Both parties' counsel should ensure that the required provisions are incorporated in the proposed sublease.

**Overlandlord Fees.** If the overlease gives the overlandlord the right to reimbursement of its legal and other fees as a condition to its consent to the sublease (as is usually the case), the subtenant should ensure that the proposed sublease requires the sublandlord to pay those fees. If the sublease is conditioned on the delivery of a recognition agreement, the overlandlord will require the sublandlord to reimburse it for all legal fees incurred in connection with the recognition agreement, and, accordingly, the subtenant should again request the sublandlord to pay the overlandlord's legal fees. In this case the subtenant may encounter some resistance from the sublandlord, who may take the view that the recognition agreement is icing on the cake or is unnecessary given the financial strength of the sublandlord. The outcome of the negotiation will ordinarily depend on the leverage of the parties.

***Overlease Provisions That May Affect Subtenant's Operations and Business***

Setting aside the hurdles the overlease can create for the act of subleasing, the subtenant's attorney needs to review the overlease with a view to determining whether the overlease contains provisions that will negatively affect the subtenant's operations and business. Because office leases are typically fairly onerous documents that are intended to give the landlord the edge in any dispute, the focus is often not so much on whether the overlease is onerous (it will be) as on whether it contains provisions the subtenant cannot comply with or that will potentially disrupt the subtenant's plans for its business. Trouble spots often include the following issues, but other issues may be raised by the terms of the overlease.

**Business Terms.** The first priority is to ensure the terms of the sublease do not conflict with the agreed terms of the transaction.

**Conflict in Terms of Overlease.** Are there any terms of the overlease incorporated in the sublease that conflict with either the terms of the sublease or with the agreed terms of the transaction? If so, those inconsistencies will have to be dealt with. Although such conflicts can usually be resolved by simply not incorporating the inconsistent terms of the overlease, it is possible that the nature of the inconsistency will necessitate either a modification of the overlease or the overlandlord's agreement in the overlandlord consent to waive that inconsistency for the subtenant, both of which options are difficult to effect because the overlandlord typically has little incentive to modify its rights under the overlease.

**Use Clause.** A narrowly drafted use clause that does not encompass the subtenant's proposed use is a problem. For example, if the use clause limits the tenant's use to "offices for an advertising agency" and the proposed subtenant is a law firm, the subtenant's use will create an overlease default. See Friedman

& Randolph, *supra*, § 7-7.2 (noting that “[a] restriction on use, included in the prime lease, binds a subtenant”). The disconnect is usually handled by including in the overlandlord consent an express consent to the subtenant’s use of the subleased premises for the subtenant’s proposed use.

If the overlandlord is aware of the subtenant’s proposed use, its consent to the sublease might be deemed a waiver of the overlandlord’s right to enforce the use clause, even if that consent does not mention the subtenant’s proposed use, especially if the overlandlord accepts rent after the sublease becomes effective; but (1) there is a risk of litigation, (2) nonwaiver provisions of the overlease may protect the overlandlord from waiver, and (3) some overlandlord consents specifically provide that the consent is only to the act of subleasing and not to the terms of the sublease, which would leave the subtenant and sublandlord exposed to a claim of breach. See Friedman & Randolph, *supra*, § 7.3.6 (stating that “[a] landlord may waive a restriction against assignment or subletting or estop himself from objecting thereto. Waiver occurs when he accepts rent after breach of the covenant or condition”).

**Assignment and Sublet Clause.** The assignment and sublet clause is critical for two reasons. It controls the sublandlord’s right to sublease to the subtenant (as discussed above), and it also controls the subtenant’s ability to dispose of the subleased space. Among other things:

*Future Sublease Transactions.* It is not uncommon for an overlease to provide that the overlandlord will not unreasonably withhold its consent to a sublease or assignment by the tenant but that any further sublease or assignment of sublease by a subtenant (and possibly any transfer of control of the subtenant) will require the overlandlord’s consent, at overlandlord’s sole discretion. Note that a provision in the overlease prohibiting assignment of the overlease does not prohibit a subtenant’s assignment of the sublease. Friedman & Randolph, *supra*, § 7:7.1.

If the sublease is for a long term or for a significant amount of space, or if the restriction prohibiting all further subleases is inconsistent with the subtenant’s business plans, that provision must be negotiated. The subtenant may seek to modify the overlease provision by including a provision in the overlandlord consent that the overlandlord will not unreasonably withhold or delay its consent to a list of designated subtenant transactions (including further subleases, assignments of subleases, and changes in control) and a provision setting out “permitted transactions” that do not require consent (for example, sub-sublease to affiliates, assignment of the sublease in connection with a sale of the subtenant’s business, or death of a principal of the subtenant). If the sublease is for a short term and the transaction is small, modification of the overlease provision through the overlandlord consent may, as a practical matter, be unnecessary because the need to assign or sublease is unlikely to arise, but the subtenant’s attorney should always consider the need for such a provision.

*Public Companies.* If the proposed subtenant is a publicly held company and the overlease provides that stock transfers are deemed assignments requiring the overlandlord’s consent and such provision is broadly enough drafted to apply to the subtenant, the provision must be modified in the overlandlord consent.

*Other Transactions.* If the subtenant plans to engage in any transaction that would violate the assignment/sublease provisions of the overlease (for example, licensing of desk space or sale of its business), the overlandlord consent to the sublease should expressly authorize such transactions.

**Expiration Date.** When does the overlease end? This is an obvious point, but the subtenant should be sure that the overlease ends after the expiration date of the sublease. If the overlease ends before the proposed expiration date of the sublease, but the tenant has an option to extend the term of the overlease, then the subtenant needs to ensure the option will be validly exercised. This is not a common problem, in part because, from the sublandlord's perspective, the point of entering into the sublease is to dispose of space, not to extend the sublandlord's liability for the space. Accordingly, most sublandlords will negotiate a sublease term that ends before the then-expiration date of the overlease. Occasionally, however, a sublease is negotiated that requires the sublandlord to exercise an extension option to give the subtenant the benefit of the extended term, in which event the subtenant needs to ensure that the extension option will be exercised. This can be a difficult problem to solve because options are normally contingent on the satisfaction of a number of conditions that cannot be satisfied at the time of the sublease—for example, a requirement that the tenant not be in default of the overlease at the time it exercises the option or at the commencement of the extension term. If the option can be validly exercised at the time the sublease is executed (with no conditions left unsatisfied), the problem is solved if the sublandlord exercises the option concurrently with the execution of the sublease and the overlandlord acknowledges the valid exercise of the option. If the option cannot be exercised at that time because there is a specified time period, which has not yet occurred, within which the option must be exercised, the subtenant could consider requiring a notice of option exercise signed by the sublandlord to be placed in escrow and delivered to the overlandlord by the escrow agent at the appropriate time, or obtaining an irrevocable power of attorney from the sublandlord to exercise the option. Both techniques, however, are subject to litigation and will not work if the sublandlord files for bankruptcy. Ultimately, the most secure way to deal with the problem is to obtain both the overlandlord's consent to and acceptance of the sublandlord's current exercise of the extension option, and also a recognition agreement protecting the subtenant's occupancy in case of the sublandlord's bankruptcy or default under the overlease.

**Insurance.** If the sublease does not directly set out the subtenant's insurance obligations, the subtenant may nevertheless be required to carry specified amounts of insurance either through the incorporation of the insurance provisions of the overlease or through the overlandlord consent. The subtenant needs to review the insurance requirements with its insurance consultant or broker and determine the added cost, if any, of obtaining such insurance. If the required insurance is beyond the subtenant's reach, the subtenant may be able to persuade the sublandlord and overlandlord to accept more limited insurance coverage, in which event the sublease and overlandlord consent should reflect the reduced coverage.

**Signage/Directory Listing.** If the overlease does not require the overlandlord to provide for both appropriate directory listings for subtenants and appropriate subtenant signage rights (for example, elevator lobby signage), then the subtenant will want those rights included in the overlandlord consent.

**Construction and Restoration.** If the subtenant intends to alter the subleased premises in connection with its move-in, subtenant's counsel should, among other things, (1) if feasible, obtain sublandlord and overlandlord consent to the proposed alterations concurrently with execution of the sublease, (2) review any limitations on alterations contained in the overlease, and (3) advise the subtenant of any costs and fees imposed by the overlease, any union requirements, and any unusual construction requirements. Any construction regulations or guidelines should be given to the subtenant and its architect for review.

Subtenant's counsel also needs to review the overlease restoration provisions (requiring the tenant to remove, at the end of the term of the lease, some or all of the alterations made by the tenant, at the election of the landlord), both because those provisions will affect subtenant's obligations for its own alterations and because the subtenant may want to remove any implication from the sublease that the subtenant is obligated to remove alterations that the sublandlord made to the subleased premises. Generally, the subtenant will be unwilling to assume the sublandlord's restoration obligations, especially if the sublandlord's alterations were unusual or expensive (for example, an internal staircase). If the subtenant can avoid such obligation, the sublandlord should end the sublease sufficiently in advance of the expiration date of the overlease to allow it to remove such alterations itself.

**Attornment.** Leases commonly include a subordination and attornment clause providing that any subtenant will attorn to the overlandlord, at the overlandlord's option, if the overlease is terminated by reason of the tenant's (sublandlord's) default. In addition, the sublease and overlandlord consent will normally provide for subordination and attornment at the overlandlord's election. Accordingly, if the overlease terminates, the overlandlord may elect to require the subtenant to remain in occupancy of the subleased space on the terms of the sublease or it may evict the subtenant. These provisions are customary, but they should be reviewed with care because the occasional attornment provision requires the subtenant to attorn to the overlandlord on the terms and conditions *of the overlease*, rather than the sublease. Because the terms of the overlease may be much more onerous, and involve payment of a significantly higher rent than the sublease, any such provision should be overturned through the inclusion of appropriate provisions in the overlandlord consent. Note that a negotiated surrender by the subtenant of the subleased premises and the sublease, if effected before any default by the sublandlord under the overlease, may leave the overlandlord powerless to require attornment. Friedman & Randolph, *supra*, § 7.7.3, citing *154 Nassau St. Realty Co. v. Pinkerton's Nat'l Detective Agency, Inc.*, 233 N.Y.S.2d 747 (App. Div. 1962), *aff'd*, 190 N.E.2d 422 (N.Y. 1963).

**Onerous Terms.** Is the overlease so completely, unusually, and idiosyncratically onerous that the subtenant should consider looking elsewhere for space? Usually the answer is no, but there is the occasional show-stopper overlease.

**Anything Else?** Every lease has its quirks, and one or more of those quirks may cause the subtenant to be in default of the requirements of the overlease, which can create issues for both the sublandlord and subtenant. Identify the quirks and deal with them in the overlandlord consent.

**Big Subleases/Small Subleases**

Counsel for a major corporation subleasing a significant block of space needs to thoroughly review the overlease and to completely understand all of its provisions and their operation. The proposed subtenant should consider reviewing past billings under the overlease to see how heavy a hand the overlandlord applies in billing taxes, operating expenses, and other charges. The financial strength of both the sublandlord and overlandlord will be of concern and will be investigated. Although the overlease may have been thoroughly negotiated and cannot be rewritten, there still may be a need to deal with unacceptable legal and economic risks raised by the overlease, either through the overlandlord consent, modification of the overlease, or through arrangements with the sublandlord incorporated in the sublease or separate agreements (which will generally have to be disclosed to the overlandlord). In addition, there will likely be a recognition agreement to negotiate and the overlandlord consent will probably be overlong and overly complex.

Counsel for a small subtenant subleasing for a short term or a small space is in a different position. The legal budget is usually limited. Fortunately, the review of a small sublease is generally simplified in that there will be no recognition agreement, and consent and recapture rights usually can be resolved through the broker's pre-clearing of the proposed sublease with the overlandlord. The overlease must still be read and understood, however. For such subleases, the focus is on determining if there are any "horribles" in the overlease. The key to good lawyering is determining what those "horribles" may be. The "horribles" will differ from lease to lease, but in general:

1. Look for the money provisions. For example, if the tenant has agreed to pay a proportionate share of the overlandlord's capital improvement expenses or to make a lump sum payment to the overlandlord, the subtenant may want to insulate itself from that liability.
2. Look for unusual allocations of responsibility. For example, the fact the tenant has agreed to make all structural repairs to the leased premises does not mean the subtenant has to agree to do so. The subtenant can avoid the obligation by simply making it clear in the sublease that it does not assume any responsibility for structural repairs or for legal compliance requirements that involve structural alterations.
3. Look for, and deal with, unreasonable assignment and sublease restrictions that will cause actual harm to the subtenant. For example, if the subtenant intends to sell its business within the next two years and the sublease has a five-year term, that transaction should be permitted under the terms of the sublease and the overlease (or through the overlandlord consent).
4. If the subtenant is subleasing a portion of the leased premises, make sure the subtenant pays only its fair share of *all* costs being passed through to it (not just the operating expenses and taxes). If the overlease operating expense and real estate tax provisions require the tenant to pay its share of increases in such costs over a base year (an escalation clause), it is customary for the subtenant's share to be recomputed using a new base year that is tied into the year that the sublease is signed. Are there cleaning, electric, and chilled water or condenser water charges and, if so, how should they be divided?
5. Make sure the attornment provisions do not require the subtenant to attorn on the terms and conditions of the overlease (attornment should always be under the executory terms of the sublease).

6. Make sure the overlandlord consent does not require the overlandlord's consent to a termination of the sublease by the sublandlord and subtenant. It is rare, but not unheard of, for a sublandlord and subtenant to enter into an agreement terminating the sublease, usually because the subtenant has outgrown the space. In those situations, the subtenant often makes a payment to the sublandlord for the termination. If the overlandlord's consent is required for any such termination, the subtenant may end up having to pay fees to *both* the sublandlord *and* the overlandlord.

### **Overlandlord Estoppel, Consents, and Recognition Agreement**

#### ***Overlandlord Estoppel***

Moving is expensive. Before committing to space, the subtenant wants to know it has a complete copy of the overlease and all related agreements, including commencement date agreements, lender nondisturbance agreements, and letter agreements, and that the sublandlord is not in default of the overlease. Accordingly, the subtenant should obtain an estoppel certificate signed by the overlandlord identifying the overlease and confirming the overlease is in full force and effect, without any modification (or stating the modifications); stating that all base rent and additional rent has been paid through the last day of the month in which the certificate is being delivered; confirming the expiration date of the overlease; and confirming that, to the overlandlord's knowledge, there are no outstanding defaults by the sublandlord under the overlease. If an overlandlord consent is being executed in connection with the sublease, the estoppel certifications are commonly included in the overlandlord consent. If the overlease does not require the overlandlord to provide an estoppel certificate, then the subtenant may have to rely on the sublandlord's certifications in the sublease and, perhaps, an informal conversation between the broker and the overlandlord's managing agent.

#### ***Overlandlord Consent***

As noted above, the overlandlord consent can be used to cure problems raised by the overlease. It also can create problems by (1) negating or modifying provisions of the overlease that operate to the subtenant's or sublandlord's benefit (for example, by imposing restrictions on subtenant assignments and subleases not contained in the overlease), (2) prohibiting any modification or termination of the sublease, and (3) requiring the subtenant, in the event of any termination of the overlease, at the overlandlord's election, to attorn to the overlandlord on the terms and conditions set out in the *overlease* (rather than on the terms and conditions of the sublease).

Also, the occasional overlandlord consent is drafted to require that the subtenant comply with all of the terms and conditions of the overlease as they pertain to the subleased premises. The intent of the language may be to make it clear that the subtenant cannot do anything the sublandlord cannot under the overlease (for example, perform alterations without consent), but the language is often considerably broader. Clearly, the subtenant is not going to comply with all of the terms of the overlease. For example, the subtenant is not agreeing to pay the overlease rent. From the subtenant's perspective it is very important to remember that the subtenant should agree only to pay the rent and perform those obligations set out in the sublease and, in the event of a termination of the overlease, to attorn to the overlandlord on the executory terms of the sublease. It is not assuming a direct obligation to the overlandlord to perform the sublandlord's obligations under the overlease, which may be very different

from the subtenant's obligations under the sublease. Accordingly, the subtenant's counsel should be alert to and modify such overly broad language—for example, by providing only that the subtenant will not take any action that would cause the sublandlord to be in default of the overlease.

For a reasonable form of overlandlord consent (which, however, does not include any estoppel certifications), see the form of overlandlord consent prepared by the New York City Real Property Committee by going to [http://www.nycbar.org/RealEstate/Forms/Sublease\\_Consent\\_Legend\\_pdf.pdf](http://www.nycbar.org/RealEstate/Forms/Sublease_Consent_Legend_pdf.pdf).

### **Recognition Agreements**

The common law rule is that if the overlease terminates by reason of a right granted the sublandlord under the overlease, the sublease falls (for example, an option to terminate or a right to terminate on the tenant's breach). Friedman & Randolph, *supra*, § 7:7.3. But, if the overlease is voluntarily terminated by the sublandlord and overlandlord and such termination was not contemplated by the overlease, the termination arguably has no effect on the sublease. Friedman & Randolph, *supra*, § 7:7.3 and note 581. The overlease also may be terminated in bankruptcy. If the sublandlord, as tenant, rejects the overlease, then 11 U.S.C. §§ 365(g) of the Bankruptcy Code, 11 U.S.C. § 1 et seq. (the "Bankruptcy Code"), comes into play, the lease (in this case, the overlease) is treated as breached, and the landlord (in this case the overlandlord) may terminate the overlease if permitted to do so by state law. See also Friedman & Randolph, *supra*, § 7.7.3. Although there have been one or two contrary cases, the general rule in bankruptcy is that rejection of a lease by the tenant will result in a termination of any sublease. E.g. *Block Props. Co., Inc. v. American Nat'l Ins. Co.*, 998 S.W.2d 168 (Mo. Ct. App. 1999). Accordingly, if the subtenant is subleasing a significant amount of space, investing a significant amount of money to alter the space, or would be otherwise materially adversely affected by a termination or rejection of the overlease leading to a termination of the sublease, the subtenant's counsel should consider conditioning the sublease on the overlandlord's execution and delivery of a recognition agreement.

Under the recognition agreement, the overlandlord agrees to recognize the subtenant as its direct tenant on the executory terms of the sublease if the overlease is terminated by reason of the sublandlord's default or bankruptcy. But the recognition agreement is usually a mixed blessing because it also typically requires the subtenant to attorn to the overlandlord (barring possible escape from an occupancy that may (or may not) have become burdensome) and to pay rent at the greater of (1) the rent payable under the overlease (generally allocated to the subleased premises on a per square foot basis, which may or may not be appropriate depending on the location and condition of the subleased premises) and (2) the rent payable under the sublease. If the overlease rent is significantly greater than the sublease rent, the potential upswing in rent may cause the subtenant to decide it will forego the protection of a recognition agreement. Accordingly, the subtenant's attorney should discuss with the subtenant, before issuance of a letter of intent, the pros and cons of a recognition agreement, and, if the recognition agreement is a critical component of the transaction, the recognition agreement requirement should be included in the letter of intent.

The overlease, if for a significant amount of space, may include a provision requiring the overlandlord to provide a recognition agreement to any qualified subtenant. For a discussion of negotiating recognition rights in overleases, see ABA Leasing Group Assignment and Sublet Committee Presentation, *The Right*

*to Sublease—Fact or Fantasy?* (Mar. 20, 2013), [https://www.americanbar.org/content/dam/aba/administrative/real\\_property\\_trust\\_estate/committee/rp2590000/leasing\\_group\\_materials\\_2013\\_03\\_20.authcheckdam.pdf](https://www.americanbar.org/content/dam/aba/administrative/real_property_trust_estate/committee/rp2590000/leasing_group_materials_2013_03_20.authcheckdam.pdf). If the overlease contains such a provision, the subtenant's counsel should determine whether or not the proposed sublease transaction qualifies under the terms of the overlease for a recognition agreement. If the proposed sublease does not so qualify, then the broker should ascertain whether or not the overlandlord will grant a recognition agreement before negotiations over the sublease commence. Recognition agreements are rarely given and, when they are given, are usually issued for substantial blocks of space being subleased to major subtenants (for example Fortune 100 companies).

### **Lender Consent**

All parties (overlandlord, sublandlord, and subtenant) need to determine whether mortgagee consent is required to the proposed sublease. Lender consent is normally an issue only for major subleases.

### **Lender Nondisturbance Agreement**

If a subordinate overlease falls in a foreclosure, the sublease also will fall. Friedman & Randolph, *supra*, § 7:7.3. For small space subleases, this is usually a risk the subtenant assumes. For major subleases, however, or ones in which the subtenant is investing a considerable amount of money, the subtenant will want to know if the sublandlord has obtained a lender nondisturbance agreement, under which the mortgagee agrees to recognize the sublandlord's tenancy under the overlease if it forecloses on the building's mortgage, assuming the sublandlord is not in default of the overlease. For such subtenants, one item on the due diligence checklist should be the existence of a lender nondisturbance agreement in favor of the sublandlord.

If the building mortgagee forecloses on the building, however, the nondisturbance agreement conditions nondisturbance on the sublandlord not being in default of the overlease, and if the sublandlord is in fact in default of the overlease, the sublandlord, and therefore the subtenant, will be unprotected because the nondisturbance agreement is conditioned on the sublandlord not being in default of the overlease. Accordingly, there is a risk the subtenant will lose the subleased premises if there is a double default—the mortgagee forecloses and the overlease falls because the sublandlord is in default of the overlease. The subtenant, in that situation, would be protected only if it had a direct nondisturbance agreement with the lender. Such nondisturbance agreements are rarely given to subtenants, because the lender will have major reservations about protecting a subtenant when both the landlord and tenant are in default of their obligations. But, if the sublease is a major investment, the subtenant is leasing the entire building (for example, under a ground lease or a triple net building lease) or a very substantial part of the building, the subtenant is very desirable, and the subtenant is willing to spend significant legal fees negotiating a lender nondisturbance agreement, it may be possible to obtain one, especially if the landlord and tenant are in precarious financial condition. Whether the risk justifies the legal cost will be a question for the subtenant, and the resolution of the issue may depend on an analysis of the financial strength of both the overlandlord and the sublandlord.

### **Due Diligence—Legal Requirements**

Due diligence for a sublease for legal requirements is essentially the same as due diligence for any lease.

The threshold question is whether the subtenant's use will be legal under local law. Because legal requirements affect occupancy rights, a few questions need to be answered: Does the zoning permit the subtenant's occupancy? Does the building's occupancy permit or certificate permit the subtenant's use? Does the subtenant, as a new occupant, have to obtain any kind of permit to occupy the subleased premises and if so, how difficult is the process?

Legal requirements also can impose alteration and repair requirements on the subtenant. Newer office buildings and class A office buildings typically comply with current legal requirements, but older buildings may not. The Americans with Disabilities Act (ADA) and local disability laws are always a concern, especially for older buildings, and especially for uses that cater to the public (such as retail stores, law firms, doctor's offices, and restaurants). The subtenant may request a representation from the sublandlord that the subleased premises and the building's path of travel comply with all applicable legal requirements, including the ADA, but is unlikely to receive such a representation for a garden variety office sublease. The subtenant, however, could negotiate for an acknowledgment that it is not responsible for compliance with existing laws, including the ADA, except to the extent compliance arises from the subtenant's particular manner of use of the subleased premises. For a major sublease, the subtenant should determine for itself if the space and the building comply with the ADA.

Pending legal requirements also are of particular concern for both tenants and subtenants. When municipalities impose significant new legal obligations on building owners, there is often a significant grace period before the obligations become effective. For example, New York City enacted a law in 2017 that requires upgrading the energy efficiency of lighting in all nonresidential spaces, together with submetering of spaces greater than 5,000 square feet, in nonresidential buildings greater than 25,000 square feet, effective in 2025. A prospective NYC subtenant subleasing space for a term extending beyond 2025 needs to determine whether the lighting in the sublease space complies with the new requirements and, if not, allocate the cost of upgrading the lighting—possibly by shifting the cost to the sublandlord through a rent credit; determine who under the sublease (sublandlord or overlandlord) will bear the cost of submetering; and review the formula, if any, under which submetered electricity will be billed.

If the subtenant plans on altering the subleased premises, it is essential to determine whether the building is subject to a union contract. Union requirements affect cost of construction, and the subtenant should be prepared to absorb those costs.

### **Physical Plant and Services Due Diligence**

As with a direct lease, the subtenant should inspect the space and investigate the adequacy of the electric, HVAC, telecommunications system, building security, premises security, elevators, the need for any repairs, and the physical plant generally. The amount of due diligence is likely to bear a direct relationship to the size of the premises subleased, but all space, no matter how small, requires some due diligence, although the due diligence will be less formal for a small space than a large space.

Subtenants subleasing small spaces customarily assume there is no need for any physical plant due diligence. After all, the sublandlord managed to operate in the subleased premises, so why not the subtenant? Nevertheless, the subtenant should be reminded of the basics: that it needs to have some assurance (if only through informal talks with the building's managing agent and its own observations) that the space has adequate electricity, HVAC, and telecommunications; and the subtenant should determine if the building is unionized because of the possible effect on costs of alterations.

Physical plant due diligence can include the following:

*Demising the Subleased Premises: Ingress and Egress.* Generally, the sublandlord should provide the subtenant with a floor plan showing the location of the subleased premises within or in relation to the leased premises, and the locations of walls, entrances, exits, and bathrooms. The plan should be reviewed by both the subtenant's architect (if the subtenant has one) and the subtenant's attorney. The floor plan will give the subtenant's attorney an idea of what the space actually looks like and whether the space includes a bathroom or kitchen. The subtenant's architect will look at the plan to see if, among other things, the space is suitable for the subtenant, provides legal access (for example, ingress and emergency egress), and has adequate HVAC. Often a review of the floor plan triggers questions about issues that need to be dealt with in the sublease.

*Amenities: Kitchen and Reception.* Is there a kitchen in the subleased premises? If so, the sublandlord should represent that the appliances will be in working order. If not, does the subtenant expect to be able to use the kitchen in the sublandlord's premises? If so, the sharing arrangement must be incorporated in the sublease. Costs relating to the kitchen also need to be considered. Is the kitchen a free amenity, or should the subtenant pay some share of the cleaning and other costs associated with the kitchen? Another question is whether the sublandlord is expected to provide reception, copier, or other services and, if so, at what cost?

*Bathrooms.* Are there bathrooms in the subleased premises and does at least one of them comply with the ADA? If not, does the subtenant expect to use common area bathrooms or bathrooms located in the sublandlord's premises? If the subtenant expects to have access to the sublandlord's bathroom, the sublease should reflect the arrangement.

*Cleaning.* In most office leases, building-standard cleaning is provided at no extra charge to the tenant. The subtenant should confirm in the sublease that it is entitled to the benefit of the services provided by the overlandlord, including cleaning, electric, and HVAC.

*Repairs and Alterations.* No matter what the size of the space, the subtenant should inspect the subleased premises. If the subtenant has an architect, the architect should tour the space with the subtenant. If repairs are required that the subtenant feels should be the sublandlord's responsibility (such as making the windows operable) or if the subtenant expects the sublandlord to paint the subleased premises, the subtenant should condition commencement of the sublease upon completion of the repairs and alterations.

*Personal Property: What Stays, What Goes.* If the sublandlord is leaving behind, for the subtenant's use, any furniture, fixtures, cubicles, or equipment, those items should be identified in the sublease. If the subleased premises include a kitchen, the subtenant should be sure to provide in the sublease that all kitchen equipment, including the refrigerator, dishwasher, and microwave (which constitute personal property rather than fixtures) shall remain with the subleased premises. As will be discussed in Part II of this article, the parties will need to determine who bears the loss in a casualty, who owns the property, whether the subtenant can remove the items during the term of the sublease (and whether they have to be returned to the sublandlord), and who is responsible for removing the property at the end of the term of the sublease (if the sublease ends concurrently or almost concurrently with the overlease).

*Building Access.* Most, but not all, buildings are open on a 24/7 basis. The subtenant needs to confirm the building's hours of access, and determine how its employees will gain access outside of normal business hours (if such access is needed).

*Security System/Card Keys.* If access to the premises is governed by the sublandlord's key card system and the entire leased premises are being subleased, the subtenant will need to arrange for issuance of new card keys on delivery of the subleased premises and for transfer of any service contract to the subtenant. If the subtenant is subleasing a portion of the leased premises and the subleased premises are separately demised with a separate entrance, the parties need to create separate security access to the subleased premises, and the sublease should allocate the responsibility for installing the separate security system.

*Supplemental Air-Conditioning.* If there are one or more supplemental air-conditioning units serving the sublandlord's server, conference rooms, or other areas within the subleased premises, the sublease should specifically provide that such units will remain with the subleased premises so there can be no arguments about whether the equipment is included with the subleased premises. Most subleases require the subtenant to accept the subleased premises and its equipment in "as is" condition. Accordingly, the subtenant should, if possible, have all of the air-conditioning equipment (including supplemental air-conditioning) inspected to determine if it is in good working order. If the equipment is not in good working order or is very old, the question becomes who is responsible for repairs if the equipment malfunctions. If the subtenant is subleasing the space in "as is" condition, it will not, for a short-term sublease, want to have to replace the air-conditioning equipment, and even if the sublease is for a long term, the subtenant is likely to be very unhappy if the air-conditioning equipment fails during its first summer of operation.

If the subtenant needs to install separate or additional supplemental air-conditioning units, the subtenant needs to investigate where such units can be installed and how the electric system can be connected to the units. If overlandlord consent is required, as is likely, the subtenant should include that consent in the overlandlord consent. The sublandlord also should consent to the installation of the subtenant's supplemental units.

If the supplemental units require condenser water and a specified number of tons of condenser water has been allocated to the leased premises, then the subtenant and sublandlord need to allocate tonnage between the subleased premises and the balance of the leased premises, as well as the cost.

### ***Building HVAC System; Overtime***

The subtenant should investigate the adequacy of the building air-conditioning system if it can. Just as importantly, the subtenant's counsel needs to determine who is responsible under the overlease and sublease for the "building" air-conditioning. Although building air-conditioning is normally the overlandlord's responsibility, in some buildings the units are located in the tenant's space and are the tenant's responsibility to repair (and therefore potentially the subtenant's responsibility). If the units are the tenant's responsibility, the parties need to determine the proper allocation of costs.

It is always a good idea to have an engineer inspect the building equipment serving the subleased premises to determine if the system is new, middle-aged, or on its last legs. If the air-conditioning system is antique, the subtenant will need to think about its options, which may include looking for other space, installing new window air-conditioning, or installing new HVAC units. For a two-year sublease, installation of new HVAC units is most often not an option. If the overlandlord has a good reputation and is under an obligation to provide air-conditioning during business hours, the risk is much less than if the overlandlord has the obligation but a bad reputation. In any event, there is no right or wrong answer if the system is antiquated. The subtenant simply has to evaluate its risk and its tolerance for malfunctioning equipment.

If the subtenant is subleasing a portion of the leased premises, another question is where the controls are located for those portions of the air-conditioning system that serve the subleased premises as well as the leased premises and whether the sublease needs to include any provisions dealing with the operation of the air-conditioning system. For example, if a conference room in the subleased premises requires supplemental air-conditioning and the controls are in the portion of the leased premises retained by the sublandlord, the subtenant will want the sublease to include a provision requiring the sublandlord to provide such supplemental air-conditioning on request.

If there is a charge for building overtime air-conditioning, sublandlord and subtenant need to determine how to allocate those charges and to provide for sharing the charges on those days when both parties are using overtime services.

### ***Telecommunications***

The subtenant needs to confirm how it will obtain telecommunications service and whether it can use its own provider in the building. The broker can often obtain this information from the managing agent. If, for any reason, the subtenant needs to run its own telecommunications lines through building common areas, it will need to obtain the consent of both the overlandlord and sublandlord to the installation.

**Electricity**

The subtenant needs to determine whether there is adequate electricity for its use. If the sublandlord's use was similar to the subtenant's use, there may not be much need for investigation. If the subtenant is subleasing part of the leased premises, the parties need to determine how to allocate the electricity charges. One possibility is to separately submeter the subleased premises. But that may not be economically feasible for a short-term or small-space sublease. In such event, the parties may elect to estimate their relative shares of the electricity charges, but, in that case, there should be provision for an equitable reallocation of each party's share if the other party vacates or if its electricity consumption otherwise significantly changes. Another possibility is to set a fixed price for electricity (for example, \$3.50 per rentable square foot) that increases annually in the same percentage as electricity rate increases.

**Banks**

Occasionally a sublandlord (for example, a law firm) provides services to banks. Banks impose strict security requirements on many of their vendors. If the sublandlord subleases a portion of the leased premises to the subtenant, the subtenant may be barred from walking through areas of the sublandlord's space that contain bank files or provide access to bank files. This is not a problem if the subleased premises are completely independent of the remaining portion of the leased premises, unless the subtenant needs access to such portion. Accordingly, if the subtenant needs access to the portion of the leased premises not subleased to the subtenant, the subtenant needs to confirm in the sublease that it will have such access.

**Signage**

If the subtenant wants lobby directory spaces, elevator directory space, elevator signage, or other signage, it should confirm with the sublandlord and overlandlord, *via* the overlandlord consent, that it will be granted such space and signage (if the overlease does not already protect it).

**Construction**

As noted above, if the subtenant intends to alter the subleased premises in connection with its move-in, subtenant's counsel should, among other things, obtain overlandlord's and sublandlord's consent to the proposed alterations (if feasible) at the time the overlandlord consents to the sublease; review (or have the subtenant's architect review) the overlandlord's construction guidelines and the overlease alteration provisions; determine if the building requires use of union labor; and determine what costs and fees will be imposed on the subtenant in connection with the alterations (and consider asking the sublandlord to assume or share the cost).

**Small Subleases**

A major corporate subtenant will have the in-house capacity to investigate the physical plant, and counsel's main role will be to elicit from the subtenant and its consultants what consents will be required and what physical plant issues will need to be covered in the sublease and overlandlord consent. A small subtenant does not have in-house capacity and typically does not have the ability to conduct a thorough investigation of the physical plant. Nevertheless, the subtenant's counsel can point out to the subtenant the basics: that it needs to determine, among other things, what repairs are needed, if the electricity is

adequate, whether the HVAC is adequate and whether it needs supplemental air-conditioning, and how the subtenant will obtain telecommunications service; and leave to the subtenant and its broker the investigation and resolution of the issues.

**Conclusion**

Subleases are interesting and complicated transactions. The subtenant's counsel must, in addition to reviewing the sublease, also review the overlease (picturing the subtenant in the shoes of the sublandlord), the overlandlord consent to determine if it modifies any of the rights or obligations of the sublandlord and subtenant, and the recognition agreement (if applicable). Although the subtenant is, in essence, taking over an already negotiated lease (the overlease), the trick is to determine whether the overlease, overlandlord consent, and related documents create any unusual risks for the subtenant and whether those risks can be ameliorated. n