



Sublease: A Necessary Solution?

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In the last few months, many national retail tenants have broadcast their desire to close a number of their locations or, possibly, all of the locations of some of their concept stores. If the tenant is not planning to liquidate, it will look for a way to ease out of locations without incurring large obligations to the landlord. A sublease to a different operator is one obvious solution for the tenant (if, of course, a subtenant is available in the market). However, the landlord may not want this new operator in its center, and both the tenant and the subtenant have interests to protect in the transaction.

The Landlord's Issues

A shopping center owner wants to keep its center filled with operating, high-quality retailers. It also needs to be sure that these retailers satisfy the tenant mix that is best for the shopping center's market position. A sublease to a low-quality retailer that does not fit within this tenant mix can be a disaster for a landlord.

To prevent such a debacle from happening, landlords generally include provisions in their leases that prohibit subleasing entirely or prohibit subleasing without the landlord's prior consent. Tenants usually ask that the landlord agree that this consent cannot be unreasonably withheld or delayed, and many landlords agree to this provision. California Civil Code § 1951.4 encourages landlords to permit tenants to sublease freely or with the landlord's reasonable consent. It provides that if a landlord has not either permitted free transfer of the lease or provided that its consent to

a transfer will be subject to reasonable standards, the landlord may not keep the lease in effect and continue the rent after the tenant abandons the space.

If the landlord is required to be reasonable, on what grounds can it object to the proposed new operator? Although the cases decided in the state will give guidance, courts tend to make these

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determinations on a factual and practical basis. Because a sublease does not release the original tenant from liability under the lease, a court might not permit the landlord to withhold its consent based on the fact that the subtenant does not have the financial ability of the original tenant. If the lease contains a very general use clause, such as "the retail sale of women's clothing and accessories," the landlord cannot object based on the subtenant's proposed use, as long as the subtenant proposes to sell women's clothing and accessories.

Even if a lease specifies that a subtenant must satisfy certain standards, e.g., that it be a national tenant with a certain number of locations and have a

net worth at least equal to that of the tenant, if the proposed subtenant clearly does not meet these standards, the landlord still should consider its options before withholding its consent. Courts do not have experience in operating shopping centers, and they might not understand the importance of a good tenant mix to the success of the center and its other tenants. If the landlord withholds its consent to a subtenant that a court might think is acceptable, then it risks having the tenant claim that it has defaulted on its obligation to be reasonable. Even if the lease does not require the landlord to be reasonable and state law does not impose a reasonableness standard on the landlord, a court might consider the rent that would have been paid by the proposed subtenant to be a mitigation amount that decreases the landlord's recovery if the tenant walks away from the lease.

Also, a landlord with empty space in its center may not want a desirable subtenant to fill an empty center space, or not want to replace a good existing tenant, particularly at a reduced sublease rent. If this is the case, the landlord's lease should state very clearly that the landlord is permitted to withhold its consent if there is comparable available space in the center. However, courts might be sympathetic to the tenant in construing this provision.

It is, therefore, very important that the landlord be sure it has good reasons for withholding its consent to a sublease. These good reasons could include the subtenant's failure to satisfy reasonable standards specified in the lease or the fact that the subtenant intends to use the space for a use that is materially different from the use permitted in the lease or that would violate another tenant's exclusive use provision.



Fortunately for landlords faced with a bankrupt tenant, the bankruptcy court's right to permit the transfer of the tenant's interest under a shopping center lease is subject to § 365(d)(3) of the Bankruptcy Code. This section of the Bankruptcy Code requires that:

- The landlord be provided with adequate assurance of the source of rent and other consideration due under the lease;
- The percentage rent will not decline substantially;
- The transferee is subject to all of the provisions of the lease, "including radius, location, use, or exclusivity provisions"; and
- The transfer "will not disrupt any tenant mix or balance in the shopping center."

Landlords presented with a subtenant by a tenant that is not in bankruptcy should probably also keep these factual considerations in mind when deciding whether to approve a subtenant.

If it approves the sublease, the landlord will want to be able to enforce lease obligations other than the obligation to pay rent against either the original tenant or the subtenant, and it will want the subtenant to be bound by the same waivers made by the tenant in the lease. This agreement and others that the landlord may want from the subtenant can be included in a three-party agreement benefiting both the landlord and the subtenant.

The Tenant's Risks

A tenant also takes a risk when it presents a subtenant to a landlord. If the proposed subtenant has no experience or plans to use the space for a use that is different from the use provided in the lease and that otherwise would seem to a court to be unsuitable for the shopping center, then the tenant is unlikely to be able to make a convincing case to the landlord—or a court—

that the landlord must accept this subtenant.

In addition, if the landlord rejects a subtenant that proposes a use that is not the lease's permitted use—particularly if the use or the nature of the tenant would not be compatible with the other tenants of the shopping center—then the tenant will have trouble convincing a court that the landlord has violated its obligation to be reasonable. If the tenant attempts to walk away from the lease after this rejection, the tenant will also find it hard to make a winning argument that

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the rent that would have been paid by the subtenant should be considered a mitigation amount that must be deducted from the landlord's damages.

If the sublease is approved and the subtenant takes possession of the space, the tenant risks incurring damages to the subtenant if the landlord does not fulfill its lease obligations. If the tenant has elected to go forward with a sublease without obtaining the landlord's consent, then even if the lease arguably permits subleasing without consent, a claim by the landlord that the subtenant is wrongfully in the space could damage the subtenant and disrupt its business. The subtenant would make a claim against the tenant for these damages since the tenant is

the one that warranted possession and services to the subtenant. Of course, the tenant can limit these risks by having the subtenant waive all claims against the tenant for the landlord's failure to perform its obligations under the lease, but many subtenants will object to this waiver.

The tenant will also incur liability to the landlord if the subtenant defaults on a maintenance, continuous operation or other obligation under the lease. These obligations are still the tenant's, and the tenant will be liable to the landlord if the subtenant is a poor operator. By use of a sublease rather than an assignment, the tenant can re-take possession of the space if the subtenant defaults, but the tenant risks the damages that will accrue during the enforcement process and the costs of re-starting operations (or buying out of the lease).

The Subtenant's Risks

If the subtenant does not obtain agreements in its favor from the landlord, its right to possession under a sublease is precarious:

1. If the lease makes the tenant's right to sublease subject to the landlord's consent and if the tenant fails to obtain this consent, then the landlord can and probably will take the position that the subtenant is not permitted to use the space.
2. If the tenant fails to pay its rent to the landlord or otherwise violates the lease, the subtenant could face eviction.
3. The subtenant may have trouble enforcing the landlord's obligation to provide utilities, common area maintenance or other services to the leased space, since it does not have a direct contractual relationship with the landlord.

These risks can be reduced substantially by an agreement directly between

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has been amortized over the term of the lease at a stated interest rate and that the rent has increased by the amount of the payment to amortize the hypothetical loan;

- That the landlord has borrowed from its lender the funds to make the improvements;
- That the improvements are special use improvements made for the express benefit of the tenant and will not have any value in the context of re-letting such space; and
- While conclusory and not binding on a court, that the landlord is offering the build-out as a "financial accommodation" to the tenant.

The prospects for success may actually be further enhanced by including the tenant improvement or allowance provisions in a separate document that is structured more as a loan agreement than a lease. A cautionary note should be sounded, however, because of the sparsity of case law and the absence, in particular, of published rulings from key bankruptcy courts in which many retail cases are filed (e.g., in Delaware and the Southern District of New York).

Conclusion

A landlord, who has agreed to build out space to the specifications of a particular tenant or to provide a tenant allowance, is faced with a dilemma if the subject tenant files for bankruptcy. If the landlord continues to perform improvements for the benefit of the tenant or pays the tenant allowance, the landlord is at risk if the tenant ultimately rejects the lease. It would seem that an equitable way to balance the rights of the landlord and tenant would be to permit the landlord to include a provision in the lease agreeing to extend the deadlines for the landlord's construction on a day-for-day basis for each day between the filing of the petition and the decision to assume the lease or delaying the payment of the tenant allowance until the tenant has assumed the lease.

However, provisions tolling landlord's obligations pending a debtor-tenant's decision to reject or assign its lease may run afoul of the *ipso facto* clause of § 365(e)(i) of the Bankruptcy Code. Nonetheless, as discussed above, through careful drafting of the tenant allowance

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the subtenant and the landlord that (i) confirms the landlord's consent to the sublease, if consent is required; (ii) provides that during the term of the sublease, the landlord will provide the lease services to the subtenant directly, and the subtenant will have the right to complain directly to the landlord if these services are not provided; and (iii) requires the landlord to accept the subtenant as its direct tenant if the original lease is terminated by a default not caused by the subtenant. This third agreement will be hard for a landlord to accept if the subtenant is paying rent that is less than the tenant's rent. A compromise could be a provision that permits the subtenant to start paying the tenant's rent and to become the landlord's direct tenant under the same terms as the original lease if the original lease terminates.

and/or construction provisions of a lease, the tenant improvement provisions of a lease may be construed as a financial accommodation, which would render the tolling provisions enforceable. ■

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Conclusion

Both the tenant and landlord can benefit from a subtenant whose use is the same as or comparable to that of the tenant. The tenant's rent will be paid by this subtenant, and the landlord will not have an empty retail space. However, it is very important that the proposed subtenant be compatible with the tenant mix in the center; and the landlord, tenant and subtenant should document the transaction in a way that reduces the real risks inherent in this type of three-party transaction. ■

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