

## In the Spotlight

### *Assignment and Subletting Provisions Rock Your World*

By Jack Garson

In the entire universe of legal and business terms that makes up the modern-day commercial lease, there are very few provisions that can change the world of the landlord or tenant. One of those world-changing provisions is the assignment and subletting provision.

Why are assignment and subletting provisions so important?

If you are the landlord, you most likely qualified your tenants based on a variety of criteria. You checked each prospective tenant's finances, background, and experience. You considered the prospect's business model, particular use, and operations for consistency with your tenant mix and vision for the property. You even went through lease negotiations that gave you a feel for how the tenant deals with a variety of good and bad situations. You don't want to lose control of your tenant selection process later and have untested, ill-fitting strangers running amok at your property.

#### **LIMITING OPPORTUNITY TO SELL?**

Likewise, the fate of many tenants is tied to their ability to assign or sublet at some point in time. For many tenants, the ultimate reason for setting up their business is to sell that business, including the requisite

assignment of their lease. A prohibition on assignment can frustrate that goal or enable the landlord to extract onerous payments or other concessions. In other instances, elaborate lease restrictions bar transfers of interests in your business, leaving you unable to bring in partners, impeding your efforts to use your business as collateral for loans, and even complicating your employee retention and estate planning.

First, consider the basics. When a tenant assigns a lease, the tenant — now the assignor — transfers all of the tenant's rights to a third party — the assignee. In contrast, when a tenant sublets to a third party — the sublessee — the tenant creates a new lease arrangement — a sublease — between the tenant and the sublessee. In a sublease scenario, the tenant retains all of its rights and obligations under the original lease, which is often referred to as the prime lease.

#### **PIZZA PARLOR PROBLEMS**

There are several notable misconceptions and common mistakes for which the record must be set straight:

- When a tenant assigns the lease, the tenant is not released from its obligations under the lease. True story: Client assigns his lease for a pizza shop in large mall. Assignee has anger management issues. Assignee shoots customer who wants a refund for a bad pizza (something about "too crispy"). Assignee cannot pay rent from prison. Land-

lord requires client/original tenant to pay rent for remaining 3 years of lease term. (After much negotiation — and a few sleepless nights — tenant cut a great deal and got out of the lease for a small fee.)

- The assignee owes no obligations to the landlord if the assignee vacates or assigns its lease.

Let's put aside the complexities of a couple hundred years of British and American case law for a moment:

There is a legal technicality that says if an assignee gives up its occupancy of the premises, there is no "privity of estate" between the landlord and the assignee, and because the assignee was not a party to the prime lease, the assignee has no obligations to the landlord. Let me personally assure you that this can be pretty disappointing news to deliver to a landlord who wants to — but can't — sue the assignee for a lot of unpaid rent.

- When a landlord consents to a lease assignment, he loses the right to approve future assignments unless he expressly reserves certain rights in the lease or in the consent letter.

- A restriction on assignment does not restrict subletting or the transfer of interests in the entity that com-



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prises the tenant. Countless tenants have avoided prohibitions on lease assignments by selling stock in their company or subletting their premises.

### LANDLORDS' PROTECTIONS

Below are some key practice pointers for landlords.

1) In your leases, include the following:

- Require the landlord's consent not just for assignment and subletting, but also for assignment or subletting of part of the premises. Similarly, require your consent for transfers of any stock or other equity interest in the tenant.
- Expressly reserve the consent requirement for each and every transfer, notwithstanding any prior consent.
- Obligate the tenant to reimburse you for reasonable legal and other expenses that you incur in considering and documenting the transfer.
- Clarify the fact that a permitted transfer does not entitle the transferee to change the permitted use of the premises.
- You may also wish to include provisions that improve your position, such as a provision entitling you to recapture or terminate the lease in the event of certain proposed transfers and/or a provision requiring the tenant to pay you a portion of any profits the tenant realizes in connection with a transfer. Some landlords go further and require tenants to forfeit certain rights, such as options to renew the lease, in the event of a transfer. Such an extreme measure is occasionally justified in a particular situation.

2) Recognize that whenever you agree that you will not unreasonably withhold your consent to a transfer, you are limiting the criteria that you may consider in withholding your consent. Generally,

the "reasonable" consent standard permits only consideration of the creditworthiness and experience of the prospective transferee.

3) Require the assignee to expressly assume the tenant's lease obligations as a direct obligation to you. This is typically accomplished in a Lease Assignment, Assumption, and Consent Agreement among the tenant, assignee, and landlord. In this Agreement, once again expressly reserve the requirement of obtaining your consent for any subsequent transfer.

4) Where you do have the right to approve transfers, remember to conduct your due diligence. Obtain financial statements and resume-type information regarding the transferee. Perhaps you will even need to require new personal guarantees, or an additional security deposit or other collateral to ensure compliance with the lease.

### TENANT PROTECTIONS

Similarly, there are also a number of well-advised practice pointers for tenants.

1) Most notably, negotiate exceptions to the requirement of obtaining the landlord's consent for important situations, such as:

- Assignment of the lease as part of the sale of your business.
- Transfers of stock or other equity interests in your business to key employees or to an Employee Stock Option Plan ("ESOP"), to your estate and/or trusts for the benefit of your heirs, and to investors as part of a private placement or public offering, as well as transfers that comprise less than a controlling interest in your business.
- Collateral assignments of your lease to a commercial lender that provides financing to your business.
- Transfers to affiliated entities, such as subsidiary, sis-

ter, and parent companies.

2) Where you are required to obtain the landlord's consent, establish a reasonableness standard or specific requirements for obtaining consent, such as minimum requirements for the transferee's net worth and years of experience.

3) Limit the landlord's ability to extract concessions in connection with any transfer:

- Cap the amount of legal or other fees for which you must reimburse the landlord.
  - Preserve your special rights, such as options to renew, although some rights, such as an option to expand, may not be justified in the event of certain transfers.
- 4) Plan for special situations that are unique to your business, such as the right of a grocery store to license concessions throughout the store without consent, or the right of a professional service business, such as a dentist, to bring in partners without landlord consent.

### CONCLUSION

While most lease provisions address countless situations in often mind-numbing detail, few have such significant consequences as the assignment and subletting provisions. You or your advisers should understand not only the basics, but also the many counter-intuitive complexities and traps that these provisions present. With this knowledge, you can add considerable value to your leases so that they do rock your world — but in a good way.

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