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Subleasing Concerns

In this article, we discuss (1) a subtenant's concerns when completing leasehold improvements on subleased premises; and (2) other pertinent issues subtenants should be aware of when entering into a sublease situation.

Issue #1:

What are the concerns regarding a subtenant completing leasehold improvements on subleased premises?

1. Ownership of the leasehold improvements -

The basic common law principle relating to leasehold improvements is that whatever is fixed to the freehold of land becomes part of it. Therefore, depending on what improvements are made, the subtenant may be foregoing ownership of the proposed additions to the land and building. Fixtures placed on leased land become part of the freehold property of the landlord. This occurs automatically by operation of law. The parties can, however, make an agreement regarding the rights in fixtures effective only as between themselves. Such an agreement will not affect the rights of third parties.

It may be helpful to add an example to clarify what is a fixture. If a leasehold improvement can be removed without damaging the structure or violating the terms of the lease, the tenant or subtenant has the right to remove it when he or she leaves. For example, the owners of a spa could opt to take their hot tubs, saunas, and body treatment equipment with them, stripping the space so that it looks like it did originally. On the other hand, if a tenant or subtenant paints the premises, removing the paint would obviously damage the structure, and so the leasehold improvement is considered the property of the landlord.

Obviously, then the concern at this stage is determining the "subtenant's" ability to own the improvements he makes to a premises. Depending on the nature of the improvements, the subtenant will have to establish up front with the sub-landlord and the landlord, ownership to any and all improvements.

2. Tax Consequences - Depending on the structure of

the sublease, the landlord or sub-landlord could offer a subtenant leasehold improvement allowances. When cash is given to the subtenant to construct leasehold improvements, the cash received by the subtenant may be deemed to be income in the year received because it enhances a subtenant's wealth by enabling it to acquire or construct suitable facilities. It should be noted that depending on the structure of subtenant leasehold improvement allowances, cash received from the landlord could be deemed a loan that is forgivable if the subtenant satisfies all of its obligations under the sublease. Further, if the subtenant owns the improvements it must depreciate the improvements constructed. If there is no subtenant leasehold improvement allowance, but the subtenant is deemed to be the owner of the leasehold improvements, the subtenant should be able to deduct the cost and depreciation of leasehold improvements reflecting the fact that these renovations are necessary for the space to be usable for specific purposes. Accordingly, appropriate depreciation procedures must be followed. **Please note that the specific tax treatment of leasehold improvements is beyond the scope of this article and you should seek a chartered accountant's opinion on these matters.**

3. Right to Monitor the Construction Process - The subtenant should make sure that it has the right to monitor the construction process, audit costs and make change orders, if necessary. If the subtenant does not control the leasehold improvement process, the subtenant should make sure that the rent commencement date is not a fixed commencement date (thereby assuming the construction risk), but instead is based on the date the sublet space is substantially completed. The subtenant might also consider negotiating the right to terminate the sublease if the sublet space is not substantially completed by a certain date.

4. Early Consent to Alterations - If the subtenant already has plans for the alterations and intends to improve the sublet space, the subtenant should obtain approval of those plans from the landlord and the sublandlord at the time the subtenant enters into the sublease in order to

eliminate the risk of later disapproval by the landlord and/or the sublandlord. If the master lease provides that the landlord is entitled to construction management fees in connection with any alterations to the premises, such fees should not be incorporated by reference into the sublease (i.e., construction management fees should not be paid by the subtenant to the sublandlord).

5. Restoration – Clarify whether any alterations must be removed at the end of the subtenant’s sublease term and by whom. Sometimes a sublandlord will require the subtenant to assume all restoration obligations, even those relating to improvements installed prior to the sublease term. Preferably, the subtenant would want to remove only those alterations which he specifically installed and only if the landlord and the sublandlord informed the subtenant he would be required to perform such removal prior to the time the alteration was installed.

6. Condition of the Subleased Premises – If there are definitely going to be improvements made to the premises, there are special issues associated with the landlord’s control of the leasehold improvements or use of tenant improvement allowance for the sublet space. If the subtenant is subleasing space which has not been substantially completed by the landlord, or if he is given a portion of the tenant improvement allowance that is provided to the sublandlord by the landlord under the master lease for completion of the subtenant’s improvements, it is important for the subtenant to obtain estoppel certificates or other statements affirming the current status of construction and describing the conditions that will be imposed on the subtenant’s use of the tenant improvement allowance for completion of the subtenant’s tenant improvements.

Issue #2:

What are the typical concerns for a subtenant entering into a sublease situation?

1. Rights of Subtenant - The most basic pitfall involves the legal status of the subtenant of a sublet space. A subtenant’s rights pursuant to a sublease are entirely dependent upon the existence of the master lease for the space. A subtenant, however, is not a party to the master lease—the master lease is the document between the landlord and the tenant; the sublease is the document between the tenant (who is the sublandlord in the sublease) and the subtenant. If the master lease terminates, so does the subtenant’s rights to the sublet space. Therefore, the subtenant must protect himself against the potential loss of its sublet space and the associated costs invested in

the sublet space.

2. Inheriting the terms of the master lease - Another basic pitfall involves the problems inherent in a subtenant inheriting the terms of a master lease which has been negotiated by its sublandlord. Most of the terms of a sublease are incorporated by reference from the master lease. However, the terms of the master lease may be entirely inappropriate for the use contemplated by the subtenant, or they may reflect the balance of negotiating power of the real estate markets at the time, as opposed to the market of today.

3. Review Master Lease - When deciding whether to sublease space, a subtenant should first analyze the master lease. It is important for the subtenant to understand all of the agreements that collectively make up the master lease. Although most subtenants review the master lease itself, many neglect to review any amendments to the master lease, estoppel certificates, non-disturbance agreements, work letter agreements, or relevant conditions, covenants and restrictions which may augment or amend the terms of the master lease. A full review of those documents is necessary.

4. Consent - It is essential for the subtenant to determine whether or not the master lease allows the sublease to occur. The landlord’s consent is almost always required for an assignment or a sublease. Most leases state that the landlord’s consent to a sublease is not to be unreasonably withheld. Factors generally recognized by the courts as reasonable concerns of the landlord include the net worth and business reputation of the subtenant and the proposed use of the sublease premises by the subtenant. It should be noted that if the landlord has financing in place, the bank may also need to consent to the subtenancy notwithstanding that there is no mention of this in the lease.

5. Recapture Right –

(a) Many leases also provide a so-called recapture right of the landlord, allowing the landlord to respond to a request for a sublease by instead terminating the lease with respect to the space proposed to be subleased. If such a recapture right exists, it is important to determine the time period in which the landlord may exercise the right, and to refrain from spending any significant amounts with respect to the sublease until it is certain that the recapture right will not be exercised.

(b) Please note that many leases are quite vague as to when the landlord must exercise the recapture right

and also when the recapture right terminates. Under a particular lease, is the recapture right triggered by merely showing the landlord a letter of intent, financial information regarding the subtenant, or the actual executed sublease? It is important to check.

6. Financial Information Disclosure - The subtenant should determine what financial and other information regarding the subtenant is required by the landlord or the sublandlord in his review of a potential sublease. Are there confidentiality concerns or other issues of the subtenant which may make it inappropriate for the subtenant to pursue the transaction? It is also important to determine if the subtenant is able to comply with any other conditions which must be fulfilled in order to obtain the consent of the landlord to the sublease.

7. Terms of Sublease - Once the subtenant has determined that the terms of the master lease will allow the sublease to occur, and that incorporation of the terms of the master lease will be acceptable to the subtenant, the terms of the sublease itself must be negotiated. The following is a list of some of the issues requiring the attention of the subtenant:

(a) Definition of Sublet Space - Although the portion of the premises subject to the master lease which is to be subleased as sublet space is often shown on a floor plan attached to the sublease, it is not uncommon for the parties to fail to understand fully whether the sublet space includes, or whether the subtenant at least has non-exclusive use rights to, lobbies, common areas, plazas, patios and lunchrooms servicing both the premises retained by the sublandlord and the sublet space. Subtenants will generally want the right to measure the sublet space after the demising improvements are completed in order to verify that basic rent and other pro-rata obligations stated in the sublease are correct.

(b) Insurance and Liability Issues - The subtenant should review the insurance requirements of the master lease to make sure that the subtenant is able to comply with the requirements to the extent that the requirements are incorporated by reference into the sublease. It is common for issues to arise with respect to the type of insurance and endorsements required of the tenant under the master lease.

If the subtenant is taking significantly less space than is set forth in the master lease, the amount of liability insurance required under the master lease may be excessive for

the purposes of the sublease.

A landlord's waiver of subrogation (i.e., an agreement from the landlord's insurance company not to sue the party causing damage to the insured) and release of liability, if any, pursuant to the master lease should also apply to the subtenant.

A master lease typically includes a provision in which the landlord limits its liability under the master lease to its equity interest in the property, and further states that the landlord is not liable for injury to the persons or property of the tenant. The landlord also seeks to exclude its liability for the tenant's consequential damages. Subtenants should try to exclude all of these provisions from a sublease, so that the sublandlord would not enjoy such exclusions, on the basis that they are inapplicable to a sublandlord/subtenant relationship

(c) Sharing Functions of the Lease –

(i) It is important for the sublandlord and the subtenant to allocate responsibility with respect to services and utilities that are provided jointly to both the sublandlord's premises and the sublet space. Are the utilities that are provided to the sublet space separately metered? If not, the parties should determine whether a sub-meter should be installed and, if so, at whose expense. In the alternative, the parties may determine a manner for the equitable allocation of the cost of the utilities. To the extent that the sublandlord has the right as the tenant under the master lease to choose certain utility providers, the subtenant might consider requiring a say in that choice.

(ii) The sublandlord and the subtenant should also consider how to approach issues related to the cost of after-hours HVAC or electrical systems. Typically, the master lease will allow the landlord to charge the tenant an additional hourly charge for after-hours HVAC or electrical use. In some modern buildings, such HVAC use may be provided separately to zones within the buildings in order to limit costs by providing the HVAC to only small portions of a floor (zones) for which the HVAC is needed. In older buildings, often many floors or the entire building must be cooled on such an after-hours basis. If the sublandlord and the subtenant are to share portions of a building in which one or more zones services both the space to be occupied by the sublandlord and the space to be occupied by the subtenant, then the sublandlord and the subtenant should discuss procedures by which each party may request such services and allocate the cost between themselves to the extent that they jointly benefit from the services.

(d) Possible problems under the Master Lease

- As mentioned above, the subtenant's right to its sublet space is dependent upon the continued existence of the master lease. In addition, the subtenant agrees to assume many of the obligations of the master lease to the extent that the obligations relate to the sublet space. Therefore, it is important for the subtenant to establish that it is not entering into a sublease that is subject to a problematic master lease. It is important to consider whether the subtenant should obtain representations and/or indemnities from the sublandlord protecting the subtenant from such problems.

(e) Indemnities - Common representations and/or indemnities to obtain from the sublandlord are: a) the master lease is the entire agreement between the parties, and there are no other agreements between the landlord and the sublandlord; b) there are no existing defaults or sets of circumstances which would lead to a default under the master lease; c) the premises and the improvements therein are in compliance with all applicable laws; and d) the premises, improvements and building systems are in good working order and condition.

(f) Landlord's Obligation to Provide Services for a Sublet Space - Typically, a master lease specifies that the landlord is to provide building services and utilities to the tenant. These services include plumbing, electricity, water, janitorial service and maintenance, and repair of common areas. However, because a subtenant does not have a direct contractual relationship with the landlord, it has no redress against the landlord for the landlord's failure to provide such services or utilities to the subtenant or other occupants of the building.

(g) Pass-through Charges - The subtenant should require that the sublandlord preserve the sublandlord's rights as the tenant under the master lease to dispute pass-through expenses (i.e., triple-net charges and other additional rent), and that the sublandlord exercise the right to dispute on the subtenant's behalf. If the sublandlord is successful in a dispute regarding pass-through expenses, the subtenant should receive the proportionate share of any credit received by the sublandlord.

(h) Protecting Subtenant from a Sublandlord's Default - A subtenant should obtain a good understanding of the financial strength of any proposed sublandlord. Does the sublandlord have sufficient financial strength to perform its obligations under the master lease?

Also, the sublandlord should covenant to promptly provide the subtenant with any notices of defaults and other matters received by the sublandlord. The sublandlord should also agree not to amend the master lease in any manner that would adversely affect the subtenant.

(i) Protecting Subtenant Against a Landlord's Default

- Because the subtenant's rights to the sublet space are dependent upon the existence of the master lease, the subtenant also has an interest in making sure that the master lease is not terminated due to a failure of the landlord (i.e., the owner of the building) to pay when due any debt encumbering the sublet space. If the landlord fails to pay such debt, and the lender forecloses as a result, any lease of the property which was executed after the loan was made may be terminated by law, unless the tenant in question has received a non-disturbance agreement from that lender, promising that the lease will survive the foreclosure, so long as the tenant is not in default under the lease.

Subsequent to a foreclosure, a subtenant's interest in its sublease will rise or fall with the status of the master lease. Therefore, a subtenant should make sure that such a non-disturbance agreement has been granted to the sublandlord.

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