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A Reprint from *Tierra Grande*

# New Sublease on Life

By Reid C. Wilson

When money gets tight, one option businesses have to increase cash flow is giving up unnecessary leased space.

If the landlord will not agree to take back the excess space or reduce rent to an acceptable level, the tenant has two options: market all leased premises for assignment to a third party or sublease a portion of the space. Landlords are generally supportive of assignment or subleasing as an alternative to a rent reduction because the tenant incurs the risk. When handled properly, this resolution benefits the landlord and provides significant economic benefits to the tenant.

#### **Assignment and Subleasing**

The assignment of a lease is the transfer of the *entire* interest of the tenant. Usually, the assignee assumes all of the original tenant's (the assignor's) liability under the lease, thus becoming directly responsible to the landlord as if they were the original tenant. However, unless the original tenant is released by the landlord, it continues to be liable if the assignee defaults.

A sublease is any transfer of rights by a tenant under a lease that does not meet the strict requirements for an assignment. Typically, a sublease is a transfer of either all of the leased space *for part of the remaining term* or part of the space *for all of the remaining term*.

The primary distinction between a sublease and an assignment is that a subtenant is *not* liable to the landlord under the tenant's lease, unless the subtenant specifically assumes the obligation to perform that lease. Tenants continue to be primarily liable on the lease to the landlord. The landlord typically has no rights to enforce the sublease directly against the subtenant, even if the landlord has consented, unless the subtenant also assumes the obligation to perform under the lease. A subtenant may not exercise a purchase or renewal option in a lease.

## Prohibition of Assignment, Subletting

Texas law prohibits both assignments and subletting without prior consent of the landlord. Therefore, as a matter of public policy, unless a lease specifically authorizes assignment and subletting, Texas tenants do not have that right.

In practice, most Texas leases specifically prohibit assignment or subletting without landlord consent, unless the tenant has significant negotiation power, as might be the case with a national retail tenant.

## Obtaining Landlord Consent

**U**nfortunately for tenants, Texas landlords need not act reasonably in withholding consent. In Texas, there is no implied duty of good faith and fair dealing in the lease relationship.

Many tenants negotiate a lease requirement that a landlord's consent to an assignment or subletting is "not to be unreasonably withheld." Courts have struggled mightily to determine an appropriate standard to describe unreasonable withholding of consent using words such as "arbitrary," "without fair side and substantial cause or reason," "capricious," "despotic" and "tyrannical."

The U.S. 5<sup>th</sup> Circuit Court of Appeals, when resolving a dispute over landlord consent, held that a landlord was unreasonable to make consent to assignment conditional on a change in the lease terms (in this case, increased rent). A Texas court held that if a landlord accepts rent directly from an assignee or subtenant, it had waived any objection to the assignment or subleasing to that party.

Some resourceful tenants have argued that selling ownership of the tenant rather than tenant's assets to a buyer is an "end

around" to a prohibited assignment and eliminates the need for an assignment or subletting document. Texas courts are mixed on the issue, but a careful tenant should request landlord consent, particularly when a material owner is exiting the tenant's business. Most landlord-drafted leases require approval for any change in ownership of the tenant entity.

## Best Choice for Tenant

**A**ssignment of the tenant's complete term and interest under a lease may be the best choice if the space is highly marketable as-is, no longer necessary or not easily divisible.

Subleasing is appropriate when assignment is not practical. Any time the tenant reserves a reversionary interest (including the right to re-entry if the subtenant defaults), the transaction is a sublease. A tenant may decide to market its space for either an assignment or sublease to maximize the chance of landing a third party to take the premises.

## Marketing the Space

In some situations, the landlord and its brokerage team will be the most knowledgeable to market the tenant's space (as long as no conflict of interest exists as might occur in a single-



**TURNING UNUSED SPACE** into cash can be just the ticket for financially stressed companies. Landlord consent is required for assignment and subleasing, both of which benefit landlords and tenants.

tenant project), and can most efficiently and effectively handle the leasing. This is particularly true when the remaining lease term is short and any new tenant will want an extension to the lease, which it will need to negotiate directly with the landlord. In this case, it may be best for the tenant to instead negotiate a lease buyout and let the landlord, whose business is real estate, handle the releasing.



**ASSIGNEES ASSUME ALL THE LIABILITIES** and obligations of the original tenant. They deal directly with the landlord if the space must be remodeled. Subtenants, by contrast, are generally asked to accept the space "as is" because any modifications are at the original tenant's expense.

In most instances, the tenant retains an independent broker to handle all aspects of the assignment or subletting. That broker coordinates with the landlord and its brokerage team as necessary, including discussing extension of the tenant's lease. This directly retained broker owes its loyalty to the tenant *only*.

In offering its space for assignment or subletting, the tenant is entering the real estate business, and must be prepared to fund an aggressive marketing program. The underlying lease is a depreciating asset (that is, the term is reducing) and the burden to pay rent continues until an assignment or subletting becomes effective. Because tenants often are economically distressed, they may be reluctant to properly fund a marketing program, but this is short-sighted.

The tenant also must be prepared to aggressively price the premises so that a new tenant is motivated to move quickly and accept the space without reservation. Focusing on the most likely candidate to actually close the deal — not necessarily the best economic deal — is key. There is no time to waste on "flaky" or "iffy" deals.

When screening candidates, the tenant should be aware of low- or no-credit assignees or subtenants that move from one low-priced space to another, motivated primarily by low rent. Such companies may move out early, stiffing the sublandlord, and reducing the benefit achieved by the sublease or assignment transaction. When selecting an assignee or subtenant, the tenant must consider itself a landlord leasing space as part of its ongoing business and be prepared to make appropriate marketing and credit decisions.

## Tenant, Assignee-Subtenant Liability

Whether assigning or subleasing, the tenant remains liable on the lease, unless specifically released by the landlord. Landlords are highly unlikely to release a tenant, even if the lease is fully assigned and assumed by a creditworthy tenant. Therefore,

the tenant has a vested interest in ensuring that the assignee or subtenant is capable of performing the lease obligations.

In an assignment, the assignee pays rent directly to the landlord. The tenant should require that the assignee contractually assume its liability under the lease and indemnify it from future liability. The tenant should monitor the assignee's payments. If the assignee defaults, the tenant should terminate the assignment and step back in to possession. Legally, this reversionary interest will make the assignment (although a complete transfer of remaining lease term and all space) a sublease. This result has no negative consequence to the tenant, which is still liable anyway, as long as the assignee assumes the lease obligations.

In a normal sublease, virtually all subtenants pay the tenant, who makes the total rent payment to the landlord for the entire leased premises. The landlord never knows whether the subtenant is in default or not. Typically, the landlord does not want any relationship with the subtenant.

A number of financial issues must be resolved in the relationship between the tenant and the assignee-subtenant.

### Upfront Payment

Sometimes a cash payment may be made by one party to the other, to induce them into the transaction. In good economic times, it would be the assignee "purchasing" the tenant's right to an assigned lease. In tough economic times, it might be the tenant paying the assignee to assume the lease obligations. A tenant would do so only if the assignee was creditworthy beyond question, as the recipient could "take the money and run." Also, the tenant may sell personal property related to use of the premises (furniture and equipment) to the assignee-subtenant through a lump sum payment, typically at a deep discount.

### Security Deposit

Assignees should reimburse the tenant for the security deposit and receive an assignment of the security deposit, thus allowing them to recover the security deposit at the end of the lease term. Subtenants typically provide a separate security deposit to the tenant, which the tenant holds, acting as a landlord.

### Rent Payment

Assignees pay rent directly to the landlord, while subtenants almost always pay the tenant, who then pays the entire rent due under the lease to the landlord. Subtenants should be concerned with the tenant's ability to pay the lease rent and will want the right to cure any default by the tenant.

## Rent Calculation

Assignees pay the face rent due on the lease. Subtenants pay rent at a rate completely unrelated to the lease rent. In almost every circumstance, this rate is significantly less.

## Expense Pass-Throughs

Assignees pay all expense pass-throughs directly to the landlord. The tenant may bill the subtenant for its pro rata portion of the expense pass-throughs for the subleased premises, or it may rent the premises on a gross lease basis (that is, without responsibility for expense pass-throughs). The tenant will pay the landlord the pass-throughs.

## Tenant Improvements

Assignees deal directly with the landlord if they wish to modify the premises. A subtenant is typically encouraged to take the subleased premises "as-is," or with modest changes (partitioning the premises, then paint and carpet only). Most subleased premises are modified to the subtenant's standards by the tenant, who deals with the landlord to effect the modifications. These changes are typically at the tenant's expense and are minimal because the tenant generally is reluctant to throw good money after bad.

## Landlord Consent

Practically, landlord consent is required in all assignment and subleasing. The tenant should contact the landlord to discuss an action plan before beginning marketing. In a multitenant building, landlords may be hesitant to sublease, and may perceive that it will compete with their own marketing of unleased space. Most landlords do not permit an existing tenant to market to a prospective new tenant that is also looking at other space owned by the landlord.

If this is not a problem, landlords typically want to ensure that a subtenant is the same caliber of tenant the landlord seeks when leasing directly. This sometimes results in a limited pool of subtenants. The landlord's goal is for the assignee or subtenant to remain in the premises under a direct lease once the term of the lease has expired.

The tenant is focused on the assignee or subtenant performing its obligations until the end of the lease term. Therefore, the parties have a shared interest in selecting a suitable assignee or subtenant.

## Relationship Documentation

Documentation of the assignment-subleasing relationship is similar to that used in a traditional landlord-tenant relationship. Initially, the business agreement between the parties

should be memorialized by a letter of intent (See publication 1629, "Commercial Letters of Intent"). After the letter of intent is signed, documentation differs for an assignment as opposed to subleasing.

For an assignment, a relatively simple document is executed by the landlord, tenant and assignee, stating that the tenant is assigning all rights in the lease to the assignee, the assignee is assuming all obligations of the tenant, and the landlord is approving the assignment and assumption. The tenant may hope the documentation contains a release of its liability, but this is not likely. Unless the assignee is creditworthy, the tenant will want the right to monitor rent payments and terminate the assignment if the assignee defaults (making the assignment, for legal purposes, a sublease).

A sublease is documented by a variation of the lease. It may use the same form as the lease document between the landlord and tenant, but cover only a portion of the premises. It is executed between the tenant and subtenant.

Landlords typically consent by a separate document that states their approval. However, many subleases are documented as a "pass-through" lease form, in which the extensive terms of the underlying lease (sometimes referred to as the "prime" or "base" lease) are referenced, and the subtenant assumes the obligation to comply with those lease provisions, *to the extent they are applicable to the subleased premises*.

This form of sublease is short and simpler in form but carries a risk for the subtenant. The subtenant should carefully review the provisions incorporated by reference. Sometimes provisions in the prime lease are not appropriate to be assumed by the subtenants and may not be in their control to perform.

Any party entering into an assignment or subletting transaction, whether landlord, tenant, assignee or subtenant, should consult a qualified real estate attorney to ensure their interests are protected. ♦

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## THE TAKEAWAY

Assigning a lease or subleasing a portion of the premises to a suitable assignee or subtenant can help commercial tenants resolve cash-flow problems. Landlords benefit too because their income stream remains the same, and they incur no additional risk.



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