

PRESENTED AT

Bernard O. Dow Leasing Institute

November 10, 2017

Houston, Texas

Sublease Negotiation Tips

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SUBLEASE NEGOTIATION TIPS

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I. INTRODUCTION

In Houston, Texas, at the end of calendar year 2016, there was over 11.1 million square feet of available sublease space. This was more than five times the amount of sublease space available in Dallas, Texas and the equivalent of the amount of sublease space available in Boston, Manhattan, and Washington, D.C., combined.¹ While the supply of local sublease office space has started to shrink, Houston by far has the most sublease space of any market in the nation, according to CBRE.² As real estate attorneys practicing in the Houston market, it is important to understand the issues and pitfalls in negotiating and drafting subleases and be able to effectively convey these issues and concerns to our clients and negotiate sublease documents which operate successfully for the prime landlord, sublandlord, and subtenant.

In the current leasing market, potential tenants are more willing to sublease space than to assume a tenant's interest in an existing lease, and existing tenants are more willing to sublease space than to assign the lease to a new tenant. This is because the liability of the parties following a sublease versus an assignment is different. Following an assignment, although the original tenant will remain liable unless the prime landlord releases the original tenant from liability, the original tenant has little control over whether the assignee performs under the prime lease and the original tenant has no means to perform such obligations in the event that the assignee does not perform. In a sublease structure, a subtenant may be able to lease less than the entirety of the prime leased premises under the prime lease, for a fraction of the rental rate under the prime lease, or for a shorter term than the prime lease, but the original tenant retains control to perform under the prime lease if the subtenant does not. Note that an assignment transfers ALL of a tenant's rights and interests in the prime lease, while a sublease transfers LESS rights than in the prime lease and the sublandlord retains a reversionary interest in the subleased premises.

II. COMMON MISCONCEPTION AND SUBLEASE FORMATS

The most common misconception is that drafting a sublease is "easy" or "simple" – a short, one-page document to which the prime lease is attached. This is not the case. Sublease documentation is more involved and complex than the documentation for a standard lease because there are multiple parties, multiple documents, and complex issues. To make matters worse, there is often pressure from either the client or a broker, or both, to quickly create a simple and inexpensive sublease document. A sublease structure has three parties: prime

¹ Houston Chronicle, *Houston Leads The Nation In Sublease Office Space*, February 27, 2017.

² Houston Chronicle, *Houston Leads The Nation In Sublease Office Space*, February 27, 2017.

landlord, original tenant/sublandlord, and subtenant, and at least two documents: prime lease and sublease.

The sublease instrument can take different forms:

- A. Prime Lease as a Template. The prime lease can be used as a template, wherein the entire prime lease is repeated in a sublease form. This results in an unnecessarily lengthy sublease document.
- B. New Lease. An entirely new lease can be drafted, so long as special care is taken that none of the provisions go outside of the boundaries of the prime lease. Again, this results in an unnecessarily lengthy sublease document.
- C. Incorporate the Prime Lease by Reference. This is the most typical sublease format. This document structure incorporates the entire prime lease by reference with a statement that all references to "Landlord" shall refer to the sublandlord, all references to "Tenant" shall refer to the subtenant, all references to "Premises" shall refer to the subleased premises, etc.; however, this structure requires careful consideration of what rights and obligations under the prime lease need to be excluded or revised for the sublease parties.

Provisions of the prime lease that are usually excluded from being incorporated into the sublease and/or specifically tailored for the sublease are: (i) rights to assign or sublease, (ii) exculpation provisions (if you represent the subtenant), (iii) sublandlord's right to self-insure, if any, (iv) rent, (v) tenant allowances, (vi) rights of first refusal, or any other preferential rights, (vii) insurance obligations of the prime landlord, (viii) representations and warranties, (ix) representations and indemnification regarding brokers, (x) parking rights, (xi) requirements to deliver an SNDA from the mortgagee, (xii) signage rights, and (xiii) prime landlord's obligation to maintain the common areas. The practitioner will need to review the prime lease in its entirety to determine whether other provisions exist that would be inappropriate to incorporate into the sublease.

III. GENERAL ISSUES

- A. Structure of the Transaction. The prime lease sets the limits of the sublease, and the sublease is always subject to and subordinate to the prime lease. If the prime lease terminates for any reason, the sublease will terminate. It is critical to the subtenant that the sublandlord timely perform under the prime lease and, if not, that the subtenant obtains rights and time to perform the sublandlord's obligations on behalf of the sublandlord.
- B. Prime Lease Limitations on Subleasing. Most leases will contain provisions regarding conditions to subleasing or limitations on the existing tenant's right to sublease the prime leased premises. These provisions should be reviewed carefully as they could affect the business terms between the sublandlord and subtenant. For example, the prime lease may require that the rental rate payable under a sublease is not less than the rental rate

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First appeared as part of the conference materials for the
2017 Bernard O. Dow Leasing Institute session

"Subleases: Negotiation Tips"