

Property & the Law

By Joshua Stein

Use Subleases to Create Value

No one likes subleasing, for many good reasons. The property owner will have someone in their building with whom they have no direct relationship. The direct tenant doesn't want the space, sticking around only to bear the loss between their rent and the subrent, plus potential exposure if the subtenant misbehaves. The subtenant worries about who will be responsible for building services, and the risk that the direct tenant will default on its lease and the subtenant will lose its sublease. The tenant must protect its interests for any space it will still occupy. The provisions of the direct lease (e.g., term, use, and operational restrictions) will constrain the sublease.

For these and other reasons, subtenants rarely pay as much rent as direct tenants for the same space for the same term. To that extent, in some sense, subleasing destroys value.

An owner can sometimes help remove some of these issues and thereby preserve value. Some of that preserved value should end up in the owner's pocket. Thus, subleasing can create opportunities—not just problems.

As a prototype, suppose a direct tenant occupies 100,000 feet at \$70. (All rents are per square foot per year.) The direct tenant no longer wants any of the space. In today's market, a direct tenant

"direct" lease. This formula gives the owner an extra \$3.50, a reasonable chunk of the \$10 difference in value between direct and subleased space.

The outgoing tenant's payment obligation would no longer constitute "rent" under a "lease." Instead it would be just a promissory note, perhaps backed by a letter of credit or collateral. A REIT property owner would need to make sure the arrangement does not create "bad income."

The outgoing tenant's nonpayment of the shortfall obligation would not entitle the property owner to evict anyone under a lease—a relatively empty threat against the tenant, who no longer needs the space anyway.

The owner would have to conclude that the transaction gives them either (a) at least as much value (after costs) as whatever direct lease they could obtain for the same space if vacant, or (b) adequate compensation for any difference. Escalations would require some attention as well.

The owner would need to accept the new occupant's credit in place of the outgoing tenant's for the new lease, or the outgoing tenant would need to sign a guaranty.

As a variation, the outgoing tenant might make one present-value payment instead of future payments. If the tenant wants to sublease only some of the space, the parties could slice it out of the lease, adjusting the rent on the remaining space. And the owner might agree to lengthen the new occupant's lease, at market.

In each case, the owner would help convert an issue-laden sublease into a direct lease that best meets the new occupant's needs—and get paid something for doing so.

Any such transaction may sound complex, but it's not much more complex than a carefully negotiated major sublease. It shifts some complexity from the outgoing tenant to the property owner. Thus, the owner may want the tenant to fund a deposit to cover the owner's attorneys' fees, in case the transaction does not close.

If an owner wants to go down this road, they need to discuss it with the outgoing tenant before the space is marketed as "sublease" space, so that the tenant can present and price the space appropriately. And the owner should make sure, early in the process, that their lender will not stand in the way.—RENY

The views expressed here are those of the author and not those of Real Estate New York.



An owner can help convert an issue-laden sublease into a direct lease that best meets the new occupant's needs—and get paid something for doing so.

might pay, let's say, \$50 for the space and a subtenant \$40. Signing a sublease would permanently destroy the \$10 difference between the "direct" value and the "sublease" value of the space.

One could restructure the transaction as an assignment of the existing lease, or a new lease, to the new occupant, but at a direct rent of, say, \$47—higher than the \$40 sublease value but lower than the \$50 direct value. In other words, because it's now a "direct" lease, the new occupant pays \$7 more than otherwise.

The outgoing tenant and the owner could split that extra revenue, by having the outgoing tenant agree to make an appropriate stream of payments to the owner. Part one of that payment stream would equal \$30, the difference between the \$70 face rent and the \$40 sublease value. As part two, though, the tenant could receive a credit of \$3.50, half the extra value that results from having a

Joshua Stein, a partner with Latham & Watkins LLP, has written extensively about commercial real estate. For more information, visit www.real-estate-law.com.