

SUBLEASING CHALLENGES

By Steve Bergsman

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Over the past couple of years **Simons Johnson, SIOR, CCIM, MCR**, a principal in the Charleston, S.C., office of Colliers International, has been working on a number of subleases. Like a good broker, Johnson kept in contact with his clients over the years and it was obvious the issue of sublease was going to come up.

“One of the key lessons I learned with the subleasing process was the amount of time that we spent prior to signing the lease,” says Johnson. “The time invested in understanding how we could demise the space and what potential cost was a major benefit to the planning process, was more than initially expected.”

When asked what else could be done to make the task easier, Johnson makes a number of suggestions: make sure your client is flexible in regard to pricing; that you work with not just the

real estate guys at the tenant company but the accounting and finance people as well; and that everyone understands the sublease won't be a profit center, that speed to get a sub-tenant is more important than a targeted sublease rate.

Subleasing is always a small part of any lease market and mostly happens because the tenant company is struggling financially, but it could just as well make sense for a company that is doing fabulously well to need more space and want to exit from a lease.

Although most leases now have a sublease clause, landlords can be a help or a hindrance to a sublease depending on how well the clause is written to give flexibility to the tenant. So, it's always good to get things right at the start, when the lease is drawn up.



And finally, to extrapolate from Johnson’s situation, the sublease needs to protect both parties if it is profitable, but most of the time it never comes close to even meeting the master tenant’s lease rate. More often than not sublease space is discounted space.

“Subleasing clauses are in most standard leases, but there are nuances,” observes **Greg Gunn, SIOR**, a senior vice president with Coldwell Banker Commercial Advisors in Salt Lake City, Utah. “The landlord may ask for the lease to read, ‘whatever profits are experienced by the tenant, after expenses, shall be shared 50-50.’”

Sounds good, but as Gunn points out, “in my career I’ve never seen a sublease tenant pay more than what the current tenant is paying.” To which he adds, “as soon as you hear the word “sublease” there is blood in the water and often attracting the market’s bottom-fishers.”

Generally, a successful sublease is one that is done quickly. First, the tenant wants out as quickly as possible, and, secondly, the sublease tenant wants in just as rapidly because the length of term of the existing lease is short—usually, only one to three years.

“When you are working a sublease space it is advisable to keep the tenant well advised when you take the listing. It is likely the space, depending on market conditions, will be subleased below the going rate. For example, if the tenant is paying \$20 a square foot, the sublease offer could be \$18 a square foot, and it may take up to six months to sublease, depending upon market conditions,” says Gunn. “However, if you reduce the sublease offer to \$16 a square foot, the odds are you will sublease the space much more quickly, perhaps as short as in 90 days. More often than not, the tenant will take the lower rate because they want to be done with it, they want to just cut and run.”

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It also helps, says Gunn, to keep the tenant well advised throughout the marketing process. Providing the tenant comparables, articles on current market conditions and what kind of discounts are being provided on sub lease spaces throughout the market, will enable the tenant to be more acceptable to a sublease rate lower than he anticipated.

The best way for a sublease deal to happen fast is to make sure the original sublease clause has the right language. The typical language in the sublease clause allows the landlord the right of approval, that a sublease can't be unreasonably withheld and that there is a time frame for approval, notes **Tom Consiglio, SIOR**, a principal at Resource Realty of Northern New Jersey in Parsippany. "A lot of the time the sublease clause allows the landlord 35 to 40 days to approve the sublease. That's too much time. Ideally, it should be five to 10 days. Usually the sub-tenants need immediate occupancy. If they feel the approval process will be difficult they'll go to the next building."

Timing and wording of the sublease clause is critical. "We've had deals crater because the subleasing clause in the lease allows the landlord a long time to review and consent to the sublease, and the subtenant wouldn't wait around. Or the sublease clause gives the landlord the right to deny consent for a broad range of reasons or any reason at all, especially in retail leases" notes "Downtown" **Jamie Brown, SIOR, CCIM**, founder and president of Hawaii Commercial Real Estate LLC in Honolulu. "It's important to check in the lease to see what the requirements are for subleasing, including procedures and timing. And then it is important to start the dialogue with the landlord early to minimize the time involved in securing consent."

One of the things to stress to the sub-lessor when looking at a sublease, Consiglio adds, is that "every month that the space sits vacant those dollars are lost and not recoverable. That's why speed is important. Getting a tenant in the space is more important than the absolute dollar amount that you sublease the space for."

While sublease clauses are standard, the language is often "tricky," notes **Steven Podolsky, SIOR**, a principal with Podolsky/Circle CORFAC International in Riverwoods, Ill.



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"If the lease is prepared by the landlord it can read that the sublease is subject to the landlord's approval and usually there is a phrase that says 'not to be unreasonably withheld,'" says Podolsky. "I take it a step further adding 'not to be unreasonably withheld, conditioned, or delayed.' I can get that added 99 percent of the time."

Every lease has a "Use clause," he adds. "If I'm representing the landlord, I want this clause to be specific as to the tenant's use, which is a hidden way to limit the tenant's ability to sublease without discussion with my client. If I'm representing a tenant and the landlord gives a broad Use clause, I don't touch it because that means my client can sublease to almost anyone who is doing business within the zoning requirements or within the law."

Podolsky has one more important tip and this one refers to the Surrender clause, which generally requires the tenant to surrender the premises on or before the termination date in the condition in which they first leased them.

"Tenants tend to sublease the premises through the very last day of their lease," Podolsky points out. "What's wrong with that? If you sublease to XYZ Company and after it moves out the place is in shambles, now the master tenant has to go in and clean-up the premises to honor that part of the lease; but, the master tenant cannot go back in because the lease is over and they have no rights to enter the premises."

That puts the tenant in default under the lease, and, at a minimum, allows the landlord to keep the tenant's security deposit and to charge the tenant for the cost of the cleanup. Podolsky suggests the sublease term should end one or two days prior to the end of the master lease. That way the master tenant can go back in and take care of any damage done by the sub-tenant.

Another tactic, says Consiglio, is to negotiate with the sub-lease tenant so that it has the responsibility of restoring the space. "If the sub-lessor is exiting the market, it doesn't want to have to bring people back years later to restore the building."

One other thing to take care of in the sublease clause: Most landlord prepared commercial leases provide that if the premises are subleased at a profit, the entire profit goes to the landlord. Podolsky always fights that clause. "A 50-50 split," he says, "is fair and reasonable. Otherwise the tenant has no incentive to try to capture the profit available in the market for themselves and for the landlord."

Consiglio hints, when initiating a sublease it is a good idea to meet with the landlord to see what the landlord's position is, also to inquire if the sub-lease tenant could buy out the lease if the sub-lease tenant wanted to, and finally, to see if the landlord might have an existing tenant who would want the space.

Brown points out, "doing a sub-lease is often more complicated and difficult than a direct lease because the broker has to get an agreement with three parties." One more thing to consider: getting paid. "If the master tenant is in financial trouble, they may not be able to pay a leasing commission," says Brown. "And many times there is a short time remaining on the term, so it may not make financial sense for the tenant to pay a leasing commission to achieve a small savings."

Finally, Gunn suggests, if all goes well with the sub-lease tenant, the company could well become a client. "You can leave this suggestion with the sub-lease tenant when you complete the transaction, 'if in two years (term of the lease) you want to stay, I'll renegotiate the lease with the landlord, but if you double in size and want to move out, I'll find you a new space.'"

Sublease clauses have become standard in most leases, but the challenges are in the details. Getting the wording right at the start will make it easier to find that sub-lease tenant if and when such a need arises.

Sublease clauses are common practice, but that doesn't mean the landlord can't make things difficult. Keep the clause as un-restrictive as possible and don't worry so much about the sublease rate as securing the sublease tenant is of paramount importance. ■

WHAT TO INCLUDE IN THE SUBLEASE CLAUSE



By **Nora Hogan, SIOR, CCIM**, executive vice president with Transwestern

in Dallas, who has done over 5 million square feet of sublease deals in her career.

1. Sub-Tenant Restriction. One of the items that is detrimental to the tenant in the sublease language is the fact that you cannot lease to another tenant in the building. The most logical prospect for sublease

space is another tenant in the building. Many times it is the tenant right next door. If you are prohibited from subleasing to that tenant then you have cut off a huge potential source for that sublease space. Sometimes landlords say no, but what you have to do is start trying to modify the best that you can. If they say you can't, what you try to add is an allowance to sublease to a tenant that is contiguous to the space.

2. Timing. Landlords always ask for 30 days to approve a sublease, but subleases happen lightning-fast, so I always try to limit consent to 10 days. Usually sublease

tenants want space immediately and they have a need to get in fast. If you have a landlord that takes 30 days to approve a sublease, it will kill that deal.

3. The Better Company. A difficult clause is the one that reads that a tenant must have financials equal to or better than your tenant. That is not in the interest of the sublease tenant. If your tenant has good financials and is going to stay on the lease as a back-up to the sublease tenant, and the subtenant isn't doing anything that is morally or ethically wrong, there is no reason why the sublease tenant's financials have to be

equal to or greater than the master tenant's financials.

4. Profit. Most landlords say you can't make a profit on a sublease and some will say they will split the profit. However, you always have to make sure in the sublease language that any profits will be split after all the expenses the tenant has incurred were deducted from the profits.

5. Marketing. Sometimes the landlord puts in a clause that says you can't advertise. That means you can't put a notice in CoStar or similar websites. This is too restrictive.