

RETAIL & OFFICE LEASING



Disposing of Excess Space May Prove Troublesome

by Theani C. Louskos

After the bubble burst on the dot-com industry and retail tenants announced store closures, substantial commercial space came back on the market as tenants tried to assign their leases or sublet their spaces. Their success in quickly disposing their excess space may depend on the terms of the assignment and subletting clause in their leases.

Negotiation of the assignment and subletting clause is often a balancing of the landlord's desire to maintain control and minimize risk on one hand and the tenant's need for flexibility to dispose of unwanted space on the other hand. Major areas of negotiation are the identity of the transferee, its proposed use, sharing of economic benefits and risk and "permitted" transfers.

Identity. A landlord wants a transferee comparable to the current tenant with the same or better credit worthiness, industry reputation and quality of operation. A tenant can agree to objective financial standards for an assignee but reputation and quality standards are too subjective.

Use. A landlord should require a transferee to operate in a manner consistent with the current tenant's use clause. However, if that use clause is broad, the landlord will want the right to deny consent to a transferee whose use does not fit the landlord's desired "tenant mix." The tenant should resist subjective requirements and instead negotiate a pre-approved list of replacement tenants or permitted uses. The parties may also negotiate limited landlord consent rights in exchange for giving the landlord the right to recapture the premises.

Economic Benefits. The landlord should receive the same or better economic benefits from the transferee as it receives from the current tenant. This is particularly important in retail leases where a tenant pays percentage rent based on its gross sales in addition to a minimum rent. If a proposed assignee cannot generate

the same level of sales as the current tenant, the landlord loses percentage rent. To avoid this result, the landlord should require that the minimum rent for any assignee be increased to the average minimum rent and percentage rent previously paid by the current tenant. The tenant should not give the landlord the right to increase rent to "fair market value" as a condition to consent.

Landlords typically want to capture any "profit" the tenant receives from a transfer including "key money" paid by an assignee or higher rent payable by a subtenant. The tenant can agree to relinquish or share profit provided the tenant first recoups its transaction costs and the unamortized cost of leasehold improvements installed at tenant's cost. To minimize economic risk, most landlords will not release the current tenant from liability under the lease in the event of an assignment. However, major tenants often negotiate an automatic release if the assignee meets a minimum net worth test.

A landlord needs to maintain control and reduce risk and the tenant needs to preserve flexibility.

Permitted Transfers. Transfers subject to the assignment and subletting clause generally are all-inclusive. However, the tenant should try to exempt certain "permitted transfers" that will not require the landlord's consent. These are typically corporate transactions, including mergers, transfers between related entities and lease transfers in connection with the sale of a tenant's business. Landlords often agree to exempt such transactions provided the tenant's financial condition is not impaired and there is no change in the tenant's operation or trade name.

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