

## So You Want to Sublease Premises – Understanding Your Risks

You need new or additional premises for your business and your real estate agent finds you the perfect space for your needs at below market rates. In your excitement at finding this great deal, you initially gloss over your agent telling you that the premises are only available as a sublet from the existing tenant of the space and not a direct lease from the owner of the building. After the initial excitement wears off, you think to ask if you should be concerned about it being a sublease and not a lease. Surely it can't be that big of a deal, right?

Well, it is. The reality is that not only is a sublease transaction more complicated than a regular lease transaction, it is a much riskier transaction for a subtenant than if it were leasing premises directly from the owner/landlord. Let's explore some of the reasons why that is and some of things that a subtenant can try to do to minimize the risks.

A sublease is basically a lease between the tenant and a subtenant on the terms contained in the sublease for all or part of the premises that have been leased by the tenant. The tenant (usually referred to as the sublandlord in the sublease) is the landlord of the subtenant. However, in a sublease transaction, there is a third party involved, namely the landlord from whom the tenant has leased the premises being subleased. The landlord is brought into the transaction for several reasons, notably because:

- most leases prohibit a tenant from subleasing its premises without obtaining the landlord's prior written consent and complying with the terms set out in the lease. As a result, most subleases have to be made conditional on the tenant obtaining its landlord's written consent to the sublease on terms acceptable to the subtenant; and
- a sublease is dependent upon the continued existence of the lease. If the lease is terminated for whatever reason, then the sublease is automatically terminated at the same time and the landlord will likely have the right to put the subtenant out on the street without any notice whatsoever to the subtenant; and
- a tenant cannot grant the subtenant any rights or interest that are greater than the tenant's rights in its lease and the subtenant cannot compel a landlord to fulfill its obligations under the lease.

Let's look at the impact of these three items.

### Landlord's Consent and Conditions in the Typical Lease

Most leases qualify the requirement to obtain the landlord's consent by saying that the landlord cannot unreasonably withhold its consent. In Ontario, such qualification is imposed by section 23 of the *Commercial Tenancies Act*, which will apply unless the lease specifically provides that the landlord may unreasonably withhold its consent.

What does the obligation to act reasonably mean? It basically means that the landlord is limited to considering the fitness of the subtenant, which boils down to having to be satisfied with the financial covenant and business practices and experience of the proposed subtenant.

To the surprise of many, it does NOT mean that the landlord has to act reasonably in considering amendments to the lease, no matter how reasonable they may be. A landlord is under no obligation to consider a single amendment to the lease or to give the subtenant any rights that have not been given to the tenant in the lease. This is not to suggest that a subtenant should not ask for things from the landlord, but to simply point out that neither it nor the tenant has any ability to force the landlord to do so.

While a lease usually imposes numerous requirements and conditions on a tenant wanting to sublease all or part of its premises, one of these is particularly problematic for a subtenant – namely, the requirement that a subtenant has to enter into an agreement with the landlord to observe and perform all of the tenant's obligations under the lease as if it had originally signed the lease as the tenant. For a subtenant, this provision is highly problematic for a number of reasons, namely:

- it is requiring the subtenant to pay the rent payable under the lease, which is often more than the rent payable by the subtenant under the sublease. If that were not bad enough, it effectively makes the subtenant the guarantor of the tenant. Once the subtenant agrees with the landlord to perform the tenant's obligations under the lease, if the tenant subsequently fails to pay rent, the landlord can insist that the subtenant pay the unpaid rent even if the subtenant has paid the tenant the rent payable by the subtenant under the sublease. If the subtenant fails to do so, the landlord can sue both the tenant and the subtenant for the unpaid rent owing under the lease.

Similarly, if the tenant fails to perform any of its other obligations under the lease, the landlord can insist that the subtenant perform them even though the subtenant may not be obligated to do so under its sublease;

- if the subtenant is only leasing part of the premises, its agreement with the landlord makes the subtenant responsible for not only the subleased premises but the balance of the premises as well; and
- finally, by saying that the subtenant has to be bound as if the subtenant had originally executed the lease as tenant, the subtenant becomes responsible for defaults under the lease that occurred prior to the commencement of the sublease.

The solution is to simply modify the subtenant's agreement with the landlord so that the subtenant is:

- not required to pay the rent payable under the lease;
- only required to observe and perform the remaining covenants in the lease during the term of the sublease and then only to the extent that they apply to the subleased premises
- not responsible for any defaults under the lease that occurred prior to the commencement date of the sublease.

However, despite the simplicity of the solution, many landlords will refuse to make these changes because they are not prepared to give up a right given to them in the lease and it (usually) makes no difference to them whether or not the sublease transaction occurs. In that case, if the subtenant is not prepared to, in effect, become a guarantor of the tenant, it will have no choice but to walk away from the sublease transaction; which is something that we have seen occur on numerous occasions.

### **Sublease being Dependent on the Lease**

As mentioned above, a sublease is automatically terminated if the lease is terminated. Somewhat surprisingly, many subtenants and their advisors do not give this a second thought, despite the potentially catastrophic consequences to a subtenant's business if it wakes up one morning to discover that its sublease is gone and it has no place from which to carry on its business. In our view, it is essential for a subtenant to address (or at least try to address) this crucial issue when entering into a sublease.

In Ontario, while the *Commercial Tenancies Act* gives subtenants certain rights to obtain a lease directly from the landlord if the tenant's lease is terminated or disclaimed in bankruptcy proceedings, there are a number of undesirable aspects to these provisions for a subtenant which make them less than ideal. Also, many (if not most) leases require a subtenant to waive these rights as a condition of the landlord giving its consent.

One thing that a subtenant can usually obtain is a covenant from the tenant in the sublease not to surrender the lease. While this doesn't solve the problem of the subtenant possibly losing the subleased premises should the tenant ignore its agreement and surrender its lease, it does give the subtenant the right to sue and, hopefully, recover from the tenant any damages that the subtenant suffers as a result of the tenant breaching its agreement not to surrender the lease.

The ideal solution for a subtenant is to obtain an option from the landlord to lease the subleased premises directly from the landlord on the terms of the sublease if the lease ever disappears. This will be difficult, if not impossible, to obtain:

- (a) if the subleased premises do not comprise all of the premises; and
- (b) if the rent payable under the sublease is less than the rent payable under the lease.

An alternative solution is for the subtenant to seek an option from the landlord to lease the premises on the terms of the lease, even though this may mean having to pay a higher rent, take more space (if the subleased premises do not comprise all of the premises) and leasing the premises for a term that goes beyond the last day of the term of the sublease. While this may not be ideal for the subtenant, it is a more palatable option for a landlord to consider since it will continue to receive the same rent and saves it the time and expense (including lost rent) of having to find a new tenant.

Despite this, it is not uncommon to see landlords refuse to give such an option to a subtenant. Their rationale is that they want to leave open all of their options and be able to pursue a better deal should one be available at the time the lease is terminated or disclaimed; especially since they know that the subtenant will likely still be there and be willing to lease the premises (possibly at a higher rent than what was payable under the lease) if the landlord decides to lease it to them.

If a landlord is not willing to entertain any type of lease option for the subtenant, the subtenant can consider asking for a period of time (say, 90 to 180 days following the termination or disclaimer of the lease) to remain in the subleased premises in order to try and find new premises and depart on an orderly basis. Landlords are often more willing to consider and grant such a request since it is unlikely that they will have a new tenant lined up to take over the premises as soon as the lease is terminated and it ensures that they get some additional rental income that they would not otherwise receive. However, if a landlord is willing to grant such a right, it will most likely insist that the subtenant pay the rent that was payable under the lease during this period if it is higher than the rent payable under the sublease.

Regardless of how the issue is addressed, from the subtenant's point of view, these rights need to be addressed. Unfortunately for subtenants, however, unless the tenant had already negotiated such a right when it negotiated the lease (which is highly unlikely), landlords are under no obligation to give a subtenant any of these rights. In that case, a subtenant will find itself in the unenviable position of having to choose between holding its nose and hope the issue never arises or walk from an otherwise favourable financial deal.

## No Greater Rights

It is important for subtenants to realize that tenants cannot grant their subtenants any rights that they do not have in the lease or which are contrary to the terms of the lease. So, for example:

- a tenant cannot grant the subtenant signage rights on the building or parking rights in the common areas if the tenant does not have a corresponding right in its lease. Even if a tenant has these rights, it is not at all unusual for some of these rights to be personal to the tenant; meaning that they are not available to be passed on to a subtenant;
- it cannot grant the subtenant a term that goes beyond the end of the term of the lease. In fact, it cannot even grant the subtenant a term that ends on the last day of the term of the lease as doing so will result in the sublease actually being an assignment of the lease to the subtenant; and
- it cannot give the subtenant the right to use the premises for a use that is not permitted by the lease.

This means that not only does the subtenant have to be concerned with the terms of the sublease, it has to ensure that the terms of the lease allow the tenant to do what it is promising to do (or allowing the subtenant to do) in the sublease.

It is also important for subtenants to realize that a sublease does not result in a subtenant obtaining any of the benefits of the lease and it does not create any relationship between the landlord and the subtenant. Among other things, this means that:

- if the subtenant wants the benefit of a provision in the lease, it has to be sure that it is addressed in the sublease;
- if there are rights that the subtenant wants which are not contained in the lease, they have to be obtained from the landlord (who is not under any obligation to grant any rights to a subtenant – or the tenant for that matter – no matter how reasonable the request may be);
- a subtenant cannot enforce the terms of the lease against either the tenant or the landlord absent a specific agreement from the tenant or the landlord. Accordingly, a subtenant needs to insist that the tenant agree in the sublease to:
  - (i) pay the rent payable under the lease when due and to observe and perform all of the other terms of the lease which are not to be performed by the subtenant; and
  - (ii) enforce the terms of the lease against the landlord, including taking steps to compel the landlord to fulfill its obligations under the lease, when requested to do so by the subtenant.

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While this article highlights some of the risks involved in a sublease transaction and some suggestions to help minimize those risks, there are a host of other issues that you need to consider and discuss with your leasing advisors when you are considering subleasing premises.



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