

## **LEASE ASSIGNMENT AND SUBLEASE AGREEMENTS**



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### **INTRODUCTION**

The benefit of real estate leases is that they may be transferred by assignment or subletting, but the advantages and disadvantages must be analyzed.

### **FORMAL DIFFERENCES**

#### Sublease

A sublease is created by a grant from the sublandlord to the subtenant of a lesser estate than the estate held by the sublandlord; therefore, it is something less than an assignment. There is no privity between the prime landlord and subtenant, which results in various losses of rights for the subtenant.

#### Assignment

An assignment of a leasehold, by comparison, is created by the transfer of the tenant's estate. An important incident of assignment is that the assignor is not automatically released, unless the landlord expressly either releases assignor or limits assignor's liability to its interest in the leasehold.

The technical result is that there is privity of estate and contract between the landlord and the assignee successor to the tenant, whereas there is no privity between the landlord and the subtenant.

If the assignor of the lease would not be released by the prime landlord and would remain liable on the lease after assignment, careful drafters try to expressly retain for the assignor the right to re-enter rather than compel a re-assignment. Otherwise, if there is a default by the assignee under the lease and the assignor had no right of re-entry, then the assignor, at least under one case, would be liable to the prime landlord, and yet would be merely a creditor of the assignee, without the express benefit of being able to mitigate those damages through repossessing and reletting the leasehold originally assigned.

#### Recharacterization

The characteristic of a sublease is that the sublandlord has a right of repossession and reversion. The more the assignment appears to resemble a sublease, or the reverse, they each can be subject to recharacterization for purposes of tax law, lease law, contract law, bankruptcy law, and financial reporting requirements. When the assignor retains a continuing interest in the leasehold estate, even though it does not retain an estate in time, the assignment may be recharacterized as a sublease. If the re-entry were deemed a re-assignment, there is a higher

likelihood the arrangement could be recharacterized as a sublease.

**TRANSFEROR'S ANALYSIS: TO BE A SUBLANDLORD OR AN ASSIGNOR.**

Sublandlord Duties

A sublandlord retains an estate and grants a lesser estate. Consequently, it has independent liabilities for traditional landlord duties; duties and liabilities it cannot avoid merely by referencing the prime lease terms and disclaiming liability for prime landlord duties. Another duty is that sublandlord generally has to avoid impairment of the subtenant's leasehold rights.

Sublandlord Administration

Another characteristic of the sublandlord's duty to the subtenant and the prime landlord is as the intermediary for administrative housekeeping. The sublandlord forwards notices, collects sublease rent, and pays prime lease rent, maintains insurance and is otherwise liable for errors in the performance of its sublandlord duties and prime tenant duties. Another issue is preservation of sublandlord rights. In the sublandlord efforts to remain aloof from the continuing dynamic of the landlord tenant relationship, a common request of subtenants, which is granted frequently but not uniformly, is that the subtenant be permitted to pursue remedies in the name of the sublandlord. This raises a variety of possible risks that the assignment would handily avoid, such as inappropriate or negligent exercise of the power resulting in unforeseen sublandlord liability.

Sublandlord Mitigation

The preeminent benefit to a sublandlord of a sublease, compared to an assignment, is the sublandlord's structural retention of the power to mitigate its own damages, a power inherent in the sublease and non-existent in the assignment. If a subtenant defaults, a sublandlord can exercise traditional landlord remedies and accelerate for rent due, or evict the subtenant, re-enter and relet the subleased premises, or terminate the sublease. The assignor cannot evict the assignee, nor repossess the leasehold, unless separately agreed to by the prime landlord. However, the sublandlord can evict the subtenant.

Interference with Assignor Rights to Reentry or Reassignment

The prime landlord would typically have requirements that an assignee have a credit quality at assignment no less than that of the tenant at commencement of the lease and the assignee at the time of the initial assignment. Interference with assignor's right to reassignment or re-entry can arise if the assignee's creditors attach liens to the leasehold; then the assignor's rights may be subject to the reassignor's judgment or creditor liens. By contrast, a sublease would always be subordinate to the

sublandlord's estate and therefore liens on the subtenant's interest in the subleasehold would be subordinate as well: the termination of the sublease terminates liens on the sublease.

#### Bankruptcy Rejection of Right to Re-Entry or Reassignment

A more extreme risk to the assignor is if the assignee files for bankruptcy and rejects the contractual obligation to allow re-entry.

#### Assignor's Independence from Ownership Risk

A benefit of the assignor over that of a sublandlord is that the assignor lacks incidents of ownership during the period of assignee's tenure. The assignor can sidestep liability that arises during that period.

#### Possession as Notice of Rights

Lastly, the assignee has much better circumstances to claim that its possession provides notice for third parties. By comparison, the subtenant's right to that standard by constructive or actual notice is much less clear.

### **TRANSFeree'S ANALYSIS: TO BE A SUBTENANT OR AN ASSIGNEE**

#### Divestiture of Subleasehold.

A subtenant has numerous concerns about the risks of a sublease, but a key concern is about the loss of the subleasehold estate for reasons outside of subtenant's control. The principal fear is that the prime landlord is entitled to terminate and divest the prime leasehold and all rights that derive from the leasehold, including the subleasehold estate.

#### Insulation of Subtenant.

As a general matter, one benefit of a sublease for a subtenant is that it can insulate the subtenant from direct liability for duties that are created under the prime lease except as otherwise expressly provided in the sublease. The liability of the subtenant under the sublease, specifically for rent, may be far less punishing than prime lease rent, though the consequence of default for nonpayment of prime lease rent may be more extreme, meaning termination of the sublease without the right to provide substitute cures. In addition, subtenant can negotiate for a number of benefits from the sublandlord that the sublandlord may not have been able to negotiate with the prime landlord, such as set off, limited liability, early termination, and tenant improvement allowances. To the extent subleases are of some smaller portion of the sublandlord premises, subtenants can also negotiate expansion options up to the boundary of the sublandlord's demised premises. Consequently, the subtenant and its guarantors, without privity with the prime landlord, can keep the prime lease requirements at a distance and, if the subtenant is

protected by a recognition agreement of its sublease contract terms, virtually irrelevant.

#### Mitigation.

From the transferee's point of view, an assignment could be less appealing than a sublease, especially because the subtenant can negotiate to require its sublandlord to mitigate damages. An assignee, by comparison, having no negotiating relationship with the prime landlord, rarely revises the impositions built into the prime lease in an equivalent fashion.

#### Independence of Assignee.

Under an assignment, the transferee would have a direct relationship with the landlord rather than an intermediated relationship as in a sublease. The assignee's right to the leasehold is not at the mercy of the assignor or shaken by its mistakes, as would be the case for a subtenant deriving its continuing right of possession from a sublandlord.

### **DRAFTING COMPARISONS AND CONTRASTS**

#### Similarities.

Comparing a sublease and a complete assignment, traditional provisions can include some of the following. Both approaches would have recitals as to the lease in question: laying the foundation for its parties, the genesis of its formation, and its subsequent history builds a framework around the intended transfer and the real property interest being transferred. The assignor and the sublandlord will both disclaim any responsibility to perform the original landlord's duties, and will insist the subtenant or assignee expressly assume the obligations of tenant under the original lease. One commonly overlooked similarity is the need for the sublandlord and the assignor to control the risk of loss arising from a subtenant or assignee failing to perform tenant obligations: they both should seek to scale back the assignee or subtenant's cure periods. That would allow sublandlord or assignor, as the case may be, to reassert its power to cure a tenant default. They would both look for remedies against the transferee, whether subtenant or assignee, including accelerated damages, right of re-entry, and rights of termination. A more obvious similarity is that both the assignment and sublease generally need a landlord consent where the prime lease has an express provision, but not where it is silent.

#### Dissimilarities.

The sublease would ordinarily elaborate the variety of provisions in the prime lease that are either included or excluded, such as how references for prime landlord are incorporated as to be deemed to mean either sublandlord, both sublandlord and prime landlord (such as for consents), or only prime landlord (such as providing utilities). An assignment

rarely addresses those issues because the assignor is cut out of the loop of participation in the landlord-assignee relationship. In that vein, a subtenant will feel compelled to describe its subrogation rights to prime tenant's position in enforcing the prime lease. The assignee already has the power by the nature of the assignment. Similarly, the subtenant would expressly create the right to compel sublandlord to enforce tenant rights, whereas the assignee would not need an express statement because that right is already embedded in the assignment.

### **MORTGAGES IN SUBLEASE AND ASSIGNMENT TRANSACTIONS**

The presence of mortgages is a complicating element for the transferee in analyzing the differences between a sublease and an assigned lease, or which of them to select if it has a choice.

#### Landlord Mortgage.

##### Senior to Prime Lease as Assigned

A prime landlord's mortgage that is prior to a prime lease would be prior to the prime lease even if it is assigned. Consequently, the prime tenant, or its assignee would be motivated to obtain a non-disturbance agreement from the mortgagee to maintain the superiority of the lease provisions over conflicting mortgage provisions, and to preserve the lease from divestiture upon foreclosure of the mortgage. Similarly, the subtenant would also be motivated to obtain a non-disturbance to, anticipate the need to sustain its prevailing rights and preserve it from divestiture if the subtenant takes over the position of the prime tenant.

##### Subordinate to Prime Lease as Assigned

A mortgage on the prime landlord's interest that is subordinate to a prime lease would be subordinate to the prime lease as assigned. Consequently, the mortgagee, rather than the tenant, would be motivated to obtain a direct assignment of rents from the landlord and an attornment agreement from the tenant or its assignee, whichever is the current holder of the lease.

##### Senior to Prime Lease as Subleased

If a landlord mortgage is senior to a prime lease, it will also be senior to a sublease. Then the prime tenant and subtenant are subject to the mortgagee's rights and each would seek a nondisturbance; the prime tenant to avoid divestiture if the mortgage is foreclosed and the subtenant to avoid divestiture if the prime lease is terminated and the landlord enters into a direct lease with the subtenant. The subtenant would also seek confirmation that its rights under the recognition agreement would not be disturbed upon a foreclosure of the senior mortgage.

### Subordinate to Prime Lease as Subleased

If a landlord mortgage is subordinate to a prime lease, it will also be subordinate to a sublease whether the sublease is earlier or later in time than the landlord mortgage, because the rights on which the sublease depends are already senior to mortgage. The mortgagee takes subject to all grants by the prime tenant, such as subleases, easements, and leasehold mortgages.

### Leasehold Mortgage.

A mortgage by the prime tenant on its leasehold would follow similar logic as the preceding analysis of the landlord's mortgage, as to interests among mortgagees, landlords, and tenants, even though they are leasehold mortgagees, sublandlords and subtenants. The change is that the overlay of the prime lease and the landlord's mortgage adds more risk of termination, more stress, by those outside forces

If the prime tenant is in default under the sublease then the leasehold mortgagee would foreclose and take over the leasehold estate. Either the sublease is senior and not divested or the subtenant would seek an SNDA with the leasehold mortgagee to be contractually protected; just the same as a fee mortgagee were foreclosing where a tenant has a leasehold.

### Subleasehold Mortgage.

A mortgage on the subtenant's leasehold is a more difficult analysis and a more remote occurrence; and, the analysis shadows the leasehold analysis, except it includes the possibilities of a fee mortgage and a leasehold mortgage so there are three levels of concern. If the prime lease predates prime landlord's mortgage, as mentioned above, the sublease and recognition agreement could be senior to the prime landlord's mortgage, and survive its foreclosure. If the prime lease is after the prime landlord's mortgage, then all derivative rights of tenants and subtenants are at risk of foreclosure without a direct non-disturber and, in the case of the subtenant, recognition agreement. If the prime leasehold mortgage predates the sublease, by the same logic, the sublease and its subleasehold mortgagee, as derivative rights, are at risk of the prime leasehold mortgage foreclosure, unless the prime lease expressly provides otherwise: the subleasehold mortgagee would seek a direct agreement that it would have the right to notice and cure for prime tenant/sublandlord's prime lease and sublease defaults, and in any event upon the bankruptcy of the prime tenant/sublandlord, notification and rights to elect possession if the prime tenant/sublandlord rejects the sublease. Similarly, the sublease mortgagee would negotiate for the right to require a new sublease in the case of a subtenant bankruptcy.

### Aligning Approvals.

The subtenant would look for consistency and alignment among the three prime parties-in-interest, meaning sublandlord, prime landlord, and

the prime landlord's mortgagee. So that, for example, it would negotiate that if subtenant received from any of them a consent to an act, a waiver, or an amendment, it would be deemed to satisfy consent requirements as to all parties. In those instances, the fee mortgagee is frequently the focus of qualifying approval.

## **BANKRUPTCY**

The different effects of bankruptcy on the prime landlord, prime tenant, subtenant and leasehold mortgagee shape how the parties design their preferred outcomes.

### Prime Landlord Bankruptcy

If the prime landlord files bankruptcy, it can assume or reject an unexpired lease. If it assumes, there is no change to the prime tenant or subtenant. If the prime landlord rejects, the prime tenant can treat the rejection as a landlord breach of the lease and either terminate the prime lease and seek damages as an unsecured creditor, or retain occupancy, perform its lease obligations and set off for its curative advances to cover other breaches of the lease by the prime landlord. The subtenant would want to control, or at least participate in, the prime tenant's decision. In the event of the prime landlord's bankruptcy, if the prime tenant acquiesces to the rejection of its lease, the prime landlord in bankruptcy may be able to both (1) reject the recognition agreement as an executory contract, and (2) refute the theory that the Bankruptcy Code entitles the subtenant to right of possession as if it were the landlord's tenant. The debtor prime landlord's argument is that it, as debtor, is not the landlord under the sublease nor is the subtenant the tenant under the prime lease. The subtenant has no privity of estate to allow the claim for continued possession. To protect against this, the subtenant, if it had the bargaining position, would take an assignment from the prime tenant of the right to exercise the prime tenant's right to retain possession." This could be structured as the adoption of a recognition agreement where the subtenant takes its future interest by assignment and assumption of the prime tenant's leasehold, rather than current substitution or current assignment of the subtenant's interest. By comparison, the assignee has privity of estate. The assignee cannot be dispossessed by a prime landlord in bankruptcy, because if the debtor landlord under the lease rejects the lease, the tenant-assignee then has a right to elect a continuing right of possession, a right which does not automatically inure to a subtenant. If the transferee tries to bridge over the risk by making a current assignment in the recognition agreement with the right of possession postponed until the termination of the prime lease, it may still hold merely an *interesse termini*. The sublease with a recognition agreement, therefore, remains at greater risk of surviving sublandlord's bankruptcy than an assignment of the leasehold.

### Prime Tenant Bankruptcy

Instead of rejecting the prime lease the prime tenant in bankruptcy has the power to assume the prime lease. Then the prime tenant, as sublandlord, can either reject or assume the sublease.

If the prime tenant is in bankruptcy, it has the power to reject the prime lease. Rejection may cause a termination of the sublease, though termination is not uniformly conceded to be the outcome. The Bankruptcy Code provides that if the tenant does not assume or reject the lease within 120 days, and if such period is not extended, the lease is deemed rejected.

### Subtenant Bankruptcy

If the subtenant is in bankruptcy, it can assume or reject the sublease. What is interesting is that at least one reported case concluded that the automatic stay in a subtenant bankruptcy prevented the prime landlord from terminating the prime lease because it would cause the subtenant to be dispossessed notwithstanding the absence of any formalized relationship of privity.

### CONCLUSION

Though the lease assignment and sublease seem to be equivalent in allowing a third party the occupancy of currently demised premises, there are significant differences in formation, operation, liabilities, and bankruptcy. The effect of accessory agreements, such as recognition agreements, non-disturbance agreements, subordination agreements and attornment agreements, can readjust by contract the rights and responsibilities set by case law and real estate law. When the latent characteristics of the various strategies are understood, and whether the direct goal can have unwanted and intended consequences, then the client can be more successfully advised.

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