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# Sublease Due Diligence

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The advertisements still seem to appear everywhere: “Prime real estate available for sublease—immediate occupancy available.” These ads conjure up vastly different images in the minds of clients and their respective lawyers. To the client seeking to lease new space, perhaps encouraged by seeing vacant commercial space all around and the rampant enthusiasm of a broker trying to earn a living, the ad conjures up beautiful visions of a steeply discounted and fast solution to its space problems, free of direct lease trials and tribulations such as waiting for the construction of tenant improvements. However, the lawyer sees the usual leasing process exponentially complicated by not two but three parties and their lenders, all with competing interests. The subtenant’s lawyer envisions a sublandlord on the brink of financial ruin, an overlandlord that won’t tinker with its “set in stone” prime lease, and a subtenant client negotiating without leverage due to an expiring lease or severe space problems.

The true situation likely lies between these two visions, yet a sublease situation is almost always more difficult to deal with than the client may think. It is the subtenant’s lawyer’s job to “kick the tires” of the sublease and make sure that the client is walking into the sublease situation with eyes open and an understanding of its legal and practical situation. It helps to have an efficient due diligence process in mind so that the possible problems involving the sublease can be brought to light or laid to rest in a rapid, cost-effective manner.

The lawyers for the overlandlord and the sublandlord also need to guide their respective clients through their own due diligence processes. The overlandlord should take a close look at the subtenant and determine whether the sublease would help or hurt the overlandlord on a long-term basis—even if the overlandlord ultimately has the right to “just say no” to the requested sublease or is desperate to avoid any more space going dark. The sublandlord will need to know how strong the subtenant really is and how the sublandlord’s prime lease liabilities will be truly affected.

Due diligence checklists for the prospective subtenant, sublandlord, and overlandlord appear in appendix 4.1 to this chapter. These checklists can serve as a starting point, but should be tailored by lawyers based on their own experiences, in light of the applicable property use and value of the lease transaction. Explanations

of the checklists are below. Section letters in the text correspond to the lettered items in the checklists themselves.

## **I. SUBTENANT'S DUE DILIGENCE CHECKLIST**

The subtenant's approach to evaluating a prospective sublease needs to be different from evaluating a direct lease, since there already is a fixed situation in place. Instead of a clean slate, the subtenant enters the picture subject to a fully written and negotiated lease, used tenant improvements, and an existing credit history and relationship between the overlandlord and the sublandlord. Therefore, the subtenant needs to ascertain the existing circumstances and either try to fit into them or undertake the additional burden of changing them.

The subtenant's due diligence process needs to ascertain as early as possible the degree of an overlandlord's willingness to deal with the sublease situation. This requires an early review of the terms of the prime lease identified in the due diligence checklist so that the subtenant knows how much of a change in the lease terms it must seek. The subtenant needs to inspect the physical space, as suggested in the checklist, as soon as possible to determine the degree of physical changes the overlandlord must approve. Also, the subtenant needs to gauge as soon as possible the financial strength, or lack of it, of the sublandlord, since ultimately this will determine the degree of cooperation of the overlandlord and the likelihood of a sublandlord bankruptcy (see chapter 19 of this book for a discussion of the consequences of this). Once the subtenant, through these due diligence items, determines the degree of change that it needs to seek and the level of incentive the overlandlord has to cooperate, then the subtenant can decide whether it is worthwhile to enter earnestly into negotiations for the sublease. If changes to the overlease or alterations to the physical space are essential, the subtenant or the sublandlord will need to convince the overlandlord that such changes are essential to the sublease and that ultimately the sublease will benefit the overlandlord (such as preventing a monetary default by a financially weak sublandlord).

### **A. Review Existing Lease Terms**

The subtenant's starting point in reviewing the overlease should be the subleasing provisions themselves. While most leases contain detailed clauses regarding the requirement of the overlandlord's consent, and conditions for the consent, once such consent is given many mechanical problems arise in completing the sublease transaction. For example, often the overlandlord will have signed loan documents that require the overlandlord's lender to consent to all leases and subleases. Yet the prime lease's sublease clause may say nothing about the lender, and even if it does, there is usually no time limit for a response from such lender in either the loan documents or the lease. As another example, the subtenant may want the ability to review documents located in the overlandlord's leasing files, such as environmental studies, operating expense records, or exclusivity provisions in other overlandlord leases, but it is the rare prime lease that provides for such access.

Beyond looking for clauses dealing with the sublease process (and the lack thereof), provisions that the subtenant will need to look out for in the prime lease include use provisions, signage rights, occupancy or continuous operations requirements that will be violated prior to the subtenant opening up for business, percentage rent provisions that may or may not be affected by the subtenant's income, the ability of the subtenant to sub-sublease or otherwise exit the transaction, and consent requirements for alterations that the subtenant is going to need to make. The subtenant also needs to check for insurance, casualty, and condemnation provisions in the prime lease, which may conflict with the anticipated treatment of such issues in the sublease.

These examples are not exhaustive. All of the prime lease provisions identified in the checklist, as well as others in any particular prime lease, can essentially tie the hands of the sublandlord and render the subleased premises unsuitable for the subtenant unless they are dealt with by prime lease amendments or otherwise. The subtenant cannot risk a default and termination of the prime lease arising from the subtenant's essential alterations, uses, hours of operation, and so forth. The subtenant will also need to understand all of the existing pecuniary obligations of the sublandlord under the prime lease so that it knows which of these obligations are likely to be passed along to it by the sublandlord. Only with such knowledge can the subtenant assess whether the subleased premises are truly appropriate for the subtenant and determine the length of the process and degree of difficulty it can expect in negotiating an acceptable sublease and amendments to the prime lease.

Perhaps the biggest problems with existing lease language occur when the sublease is only a partial sublease of the existing premises. In such a situation, the sublandlord or another subtenant may in essence become co-lessees under the existing prime lease, making it difficult to include many of the protections that the subtenant would ordinarily require in the sublease from the sublandlord (because the sublandlord continues to have a possessory, as well as pecuniary, interest under the prime lease). The subtenant will need to make sure that it understands each and every obligation of the sublandlord, so that the sublease effectively and fairly allocates such responsibilities going forward between the sublandlord and the subtenant.

One prime lease provision that is always key to the subtenant will be the length of term. A sublease is usually of a length of term less than a direct lease. Therefore, the subtenant will most likely require that it be able to exercise renewal obligations under the prime lease or, if such renewal is unacceptable to the sublandlord, obtain an agreement from the overlandlord to enter into a new direct lease with the subtenant after expiration of the existing prime lease.

## **B. Assess Physical Condition of Premises**

The subtenant will either desire to utilize the existing tenant fit-out to the extent possible, or change it to meet its own needs. Regardless of which is the case, the existing condition of the premises and tenant improvements needs to be fully

understood by the subtenant so that the subtenant can assess its need to make further alterations, the feasibility of such alterations given the existing structure, the need for future maintenance, and the anticipated cost of all of these concerns. The assessment of the condition must occur before the subtenant seeks any necessary approval from the overlandlord for further alterations.

Physical inspections by appropriate experts could include review of existing wiring, telecommunication conduits, load-bearing capacity, and major systems maintained by the sublandlord such as heating, air conditioning, plumbing, telephone, fire suppression, security, and card-entry systems.

The subtenant, depending on the nature of the premises, may need to obtain comfort on environmental risks and establish a documented environmental baseline to protect itself from future liability. Concerns can include a broad array of problems that may require separate inspections, such as mold, indoor air quality, radon, asbestos, groundwater, underground storage tanks, and hazardous waste. The subtenant and its inspectors will need to obtain access to the premises as well as to the sublandlord's files and past reports. Although it is often not done, the prudent subtenant and its experts should also review the files and records of the overlandlord, if such access can be obtained or negotiated (prime leases rarely provide for such a right).

### C. Ensure Compliance of Premises with Laws

The subtenant needs to make sure that its operations will not be shut down by governmental authorities (or by the overlandlord under the terms of the overlease) for failure to comply with zoning, land use, or building codes. The subtenant will also need to know whether alterations are needed for the premises to comply with provisions of the Americans with Disabilities Act (ADA) so that the subtenant is not exposed to pertinent liability from private plaintiffs as well as governmental authorities. If the subleased premises did not constitute new construction after the adoption of the ADA, the subtenant may be instituting a new use that now renders the premises a "public accommodation" (basically, sites at which goods or services are provided to the public, such as restaurants and retail stores), for which the ADA imposes heightened requirements for barrier removal. Another concern is whether alterations that the subtenant will be making might destroy grandfathered code status of the current improvements.

To deal with these issues the prudent subtenant will employ an engineer to survey the premises for compliance. This should always include an analysis of the parking provided at the premises. While the premises may have more than the number of parking spaces required for the sublandlord's use, the subtenant may have a slightly different use. Under some local land use laws, parking requirements may differ for a fast-food restaurant, a traditional table service restaurant, and a "take-out" restaurant (be careful when you add those tables to your donut shop!). Alternatively, the subtenant may have the same use but a greater number of employees, which could require a greater number of parking spots under the zoning regulations. If at all possible, the subtenant should

require production of all certificates of occupancy for the leased premises. The subtenant should also determine whether it needs to obtain a new certificate of occupancy for its possession.

#### **D. Confirm Status of Ownership**

The prudent subtenant will obtain a title search on the real property (ideally coupled with a leasehold title insurance policy if the sublease is valuable and can be recorded), and will also obtain a complete Uniform Commercial Code (UCC) financing statement search in the names of both the overlandlord and the sublandlord. The searches should verify that the overlandlord has fee title or an acceptable leasehold interest in the real property and determine if there are any security interests in the personal property included in the sublease. The UCC search will also reveal whether a third party is claiming title to certain goods and only leasing them to the sublandlord. The title search also informs the subtenant of leases of record of the premises to parties other than the sublandlord, whether the premises are free of mechanic's or judgment liens against either the sublandlord or the overlandlord, and whether any lenders have mortgages secured by the premises (in which case the consent of those lienholders to the sublease may be required).

#### **E. Determine Existence and Status of Service Contracts**

There are a great variety of ongoing service contracts that may be necessary for operation of the leased premises, including heating, ventilation, and air conditioning (HVAC) service contracts, sprinkler and fire-suppression systems contracts, property management contracts, satellite or other communications service provider contracts, security contracts, trash removal contracts, and cleaning contracts, as well as basic utility accounts. If any of these contracts have been entered into directly by the sublandlord, as opposed to the overlandlord, most likely the sublandlord will ask the subtenant to assume the contracts or instead terminate existing contracts and require the subtenant to enter into new ones. Knowledge of these contracts and their terms not only helps the subtenant determine operating costs of the premises going forward, but also can give an indication of the past maintenance of the premises. The subtenant will need to verify that there are no outstanding obligations of the sublandlord under a contract and that the terms of the existing contract are acceptable before agreeing to enter into the contract. Since these types of contracts are often informal and oral, the diligent subtenant may need not only to require written representations from the sublandlord listing the contracts and their basic terms but also to verify the existence of the contract terms and their payment and default status with the service providers themselves. The subtenant needs to have a contractual right to cause the sublandlord to terminate these contracts prior to commencement of the sublease if their terms are not acceptable; ideally, the subtenant should have knowledge of truly significant service contracts ahead of time so that they can be covered in the written sublease itself.

#### **F. Determine Whether Prime Lease Could Be Terminated or Could Subject Subtenant to Unknown Legal Liabilities**

The primary method the subtenant will employ to make sure the prime lease is not terminated, thus eliminating its sublease, is to obtain a comprehensive estoppel certificate from the overlandlord and sublandlord. However, a bit of due diligence in this area beyond the certificate certainly would not hurt. The prospective subtenant may be able to obtain valuable information from talking with the overlandlord's property manager or leasing broker, as well as from the overlandlord itself and other tenants in the building or shopping center that contains the premises.

Even if there are no existing defaults under the prime lease, the financial abilities of the sublandlord are of paramount concern to the subtenant. A financially weak sublandlord may fail to meet its obligations under the prime lease, rendering the subtenant compelled to pay higher rent under the prime lease or other obligations that may have been allocated to the sublandlord under the sublease in order to keep the prime lease in effect. This is especially true with a partial sublease, when the sublandlord or another sublessee is effectively sharing payment obligations with the subtenant under the prime lease. Moreover, if the sublandlord files bankruptcy, the prime lease and the sublease both become executory contracts that could be rejected by the sublandlord.

Finally, often overlooked is due diligence that should be performed by the subtenant to determine the financial stability of the overlandlord. Again, the prime lease could become embroiled in a bankruptcy, affecting or even eliminating the sublease; or the overlandlord may be unable to perform its maintenance or other obligations due to financial weakness.

Methods of determining the financial status of the overlandlord and the sublandlord include such things as Dun & Bradstreet reports, credit reports, and financial statements.

#### **G. Determine Authority and Ability of Parties to Be Contractually Bound**

It is surprising that lenders, even for very small loans, will go to great lengths to ensure that the loan documents have been duly authorized, executed, and delivered and that the borrower has the power and authority to enter into the loan transaction, while such verification is rarely obtained in all but the largest of lease transactions. The subtenant needs to know that both the sublease and the overlandlord's estoppel certificate are valid, enforceable, binding, and not subject to such defenses as lack of due authorization or lack of the power of the organization to enter into such documents.

At a minimum, the subtenant should obtain a resolution signed by the secretary of a corporation, by all members of a limited liability company, or by all partners of a partnership, as applicable. The subtenant should also ask for copies of the applicable filed documents creating the sublandlord and overlandlord entities, as well as their bylaws, operating agreements, or partnership agreements

as applicable, so that they can be reviewed to make sure that the sublease transaction and prime lease transaction are not outside of the organizational power of the entity and have in fact been properly approved in the resolution by the necessary parties. The person signing the sublease or estoppel needs to be specifically authorized either in the resolution or by the terms of the organizational documents of the entity.

#### **H. Determine Financial Strength of Sublandlord and Overlandlord**

The subtenant will want to obtain whatever documentation it can to assess the financial strength of both the overlandlord and the sublandlord, in order to determine the likelihood that such parties can perform their obligations under the prime lease and the sublease or whether the sublease itself will be affected due to an overlandlord or sublandlord bankruptcy.

## **II. SUBLANDLORD'S DUE DILIGENCE CHECKLIST**

Due diligence for the sublandlord is critical, despite the fact the sublandlord is already familiar with the leased space and prime lease obligations. The sublandlord's due diligence should be focused on making sure that the sublandlord achieves its primary objective of having a third party undertake as soon as possible the sublandlord's existing lease obligations through the end of the prime lease term. The sublandlord may view the due diligence process as subversive to its timing objectives; however, a sublease undertaken without the proper investigation can often lead to temporary, rather than extended, relief of the sublandlord's prime lease obligations.

#### **A. Determine Financial Strength of Subtenant and Overlandlord**

Certainly, the subtenant's accountant-certified financial statements, a credit report on the subtenant, copies of filed tax returns, and a direct inquiry of the subtenant regarding its financial status are all valuable tools for determining financial strength. Indeed, except in the very rare circumstance where the prime lease allows the sublandlord to sublease without any approvals from the overlandlord, the subtenant should be absolutely sure that the subtenant is a reasonably strong party before the sublandlord expends any "political capital" in requesting the overlandlord's consent. The sublandlord cannot afford to build up any ill will with the overlandlord during this critical time by wasting the overlandlord's time with a financially weak subtenant candidate.

Ideally, the sublandlord should also assess to the extent possible the overlandlord's financial strength, for purposes of assessing the risk of an overlandlord bankruptcy, which could leave the sublandlord liable for obligations in the sublease that cannot be performed. Yet, very few leases obligate the overlandlord to provide financial information to the sublandlord.

### **B. Review Prime Lease to Determine Rights and Leverage of Sublandlord**

The sublandlord always needs to take a fresh look at its existing prime lease in light of the current status of the lease and any specific language that the sublandlord has regarding prospective subtenants. This will allow the sublandlord to predict how cooperative the overlandlord will be in the sublease process and the extent to which the sublandlord, rather than the overlandlord, will be able to continue to control the sublease process. The first terms to review in the lease are the subleasing and assignment provisions, which often very specifically spell out the landlord's consent rights and, with increasing regularity, the agreed-upon conditions that render an overlandlord's failure to consent to be reasonable. However, there are many other lease provisions, such as those listed in the checklist, that can interfere with the prospective subtenant's requirements and may require the sublandlord to approach the overlandlord hat in hand for prime lease amendments (or waivers in the overlandlord's consent document).

The sublandlord also needs to know if there is an ability of the overlandlord to recapture the premises and instead deal with the subtenant directly under a new prime lease.

### **C. Determine Ability to Make Representations and Warranties or Estoppel Statements Required by Subtenant**

The sublandlord will undoubtedly need to provide an estoppel certificate to the subtenant that confirms the existing status of the lease. The sublandlord will need to undertake the same due diligence analysis that it would undertake in providing an estoppel letter to a lender or purchaser of the premises. Therefore, it needs to be careful in making sure that the correct personnel are questioned and its leasing files reviewed to avoid misstatements. Often, this is lost in the mad rush to get the sublease executed. Yet there is no reason for this to occur since this due diligence can be conducted prior to beginning the subleasing process. Even before receipt of a requested form from the subtenant, the sublandlord can rather easily predict the statements that will be requested—including verification of the lease terms, default status, and the status of rent payments.

### **D. Determine Whether Future Activities of Subtenant Could Render Prime Lease in Default**

In a true sublease situation, the overlandlord will not release the sublandlord from any obligations, past or future, under the prime lease. Since the sublandlord enters into a sublease either to have another party undertake the existing obligations of the sublandlord under the prime lease or to capitalize upon the economic value of its interests under the prime lease, the last thing the sublandlord wants is any default situation created by the subtenant under either the prime lease or the sublease. Due diligence also plays a role in this determination



of the likelihood of future subtenant defaults and preventing prime lease default situations up front.

The sublandlord needs to conduct a thorough inquiry of the subtenant to understand and predict the subtenant's future use of the premises. To be properly done, this not only requires asking a series of probing direct questions regarding the subtenant's current plans for use, alterations, hours of operation, and so forth; it also requires gaining at least a general understanding of the subtenant's business so that the sublandlord can envision the future of that business and gauge the likelihood of future pressures that could lead the subtenant to default under the prime lease or abandon the sublease. For example, a retailer could be subject to changes in its competition that could force it to enter into new lines of business to stay competitive, lines that might violate use provisions or require alterations that are unfeasible for the premises. For another example, the subtenant may want to add signage that is permitted under land use laws but is prohibited under the prime lease. Once the sublandlord understands what the subtenant's operations are likely to be, the sublease can be drafted with covenants that fully guard against future prime lease defaults. This requires more than a blanket covenant that the subtenant comply with all terms of the prime lease, since prime lease provisions can be ambiguous when applied to specific situations that can be explicitly prevented in the sublease.

To best protect its interests, the sublandlord should monitor the subtenant's performance throughout the term of the sublease. The due diligence undertaken by the sublandlord to understand the subtenant's operations before the sublease is signed will only make this ongoing monitoring process more effective.

#### **E. Determine Authority and Ability of Subtenant to Be Contractually Bound**

As discussed above in the context of the subtenant's checklist, the sublandlord will want to make sure that the subtenant has the power and authority to enter into the sublease, and that a proper person has executed the sublease with authority to bind the subtenant. The degree of diligence undertaken to verify this, which in theory should be the same for all transactions, as a practical matter will vary according to the size of the transaction.

#### **F. Determine Status of Existing Service Contracts**

The sublandlord is well advised to take a look at its existing service contracts for such things as sprinkler and fire-suppression systems, HVAC maintenance, alarm systems, trash removal, cleaning, and so forth—in fact, all contracts directly entered into by the sublandlord instead of the overlandlord—before beginning sublease negotiations. After all, the sublandlord should have the same desire to relieve itself from these contractual liabilities and expenses as it does to be relieved from the prime lease obligations. The focus of this review should be upon those service contracts that the sublandlord is not required to keep in effect under the

terms of the prime lease. The sublandlord will primarily use its review to classify these contracts into two categories: those that can be terminated at or prior to the sublease (which the sublandlord should almost always terminate, so that the subtenant enters directly into replacement contracts); and those that cannot be terminated prior to the sublease (either by their terms or by negotiations with the service provider). With a knowledge of the contracts that must continue, the sublandlord can commence sublease negotiations with a requirement that the subtenant contractually assume these obligations. The sublandlord should also determine whether it has any outstanding payments or other obligations under these contracts.

As to those services that the sublandlord is required to keep in effect under the prime lease terms, the sublandlord will need to decide whether it is better off keeping these contracts in its own name, which although not relieving the sublandlord from direct liability will provide greater control in avoiding a prime lease default; or, instead, terminating them and having the sublease require the subtenant to carry them. The sublease can best be drafted to protect the sublandlord in this regard when the sublandlord determines its strategy up front.

### **III. OVERLANDLORD'S DUE DILIGENCE CHECKLIST**

The overlandlord is often drawn reluctantly into the sublease transaction. After all, the overlandlord has already drafted and negotiated the prime lease and has already incurred the transaction costs for the prime lease, which it expected to spread over the entire length of the prime lease term. In addition to time, the overlandlord may have invested capital in the form of tenant improvement allowances for the sublandlord. However, the prudent overlandlord will use the sublease opportunity to protect its position by improving the credit position it has with a failing sublandlord; perhaps facilitate a prime lease renewal or set the stage for a future prime lease due to the subtenant's continued need for the space; or possibly even improve the prime lease terms by virtue of the sublandlord's need for the overlandlord's consent. Thus, the overlandlord is faced with a key business decision that can be properly made only after exercise of requisite due diligence.

#### **A. Determine Financial Strength of Sublandlord**

The overlandlord may not want to deal with a subtenant that it does not know or did not originally seek if the sublandlord is fully capable of continuing to perform its lease obligations. On the other hand, if the financial ability of the sublandlord has diminished to the point at which future compliance with the lease terms are in jeopardy, or a possible loss of control of the leased premises through a bankruptcy filing of the sublandlord looks possible, the overlandlord may become highly motivated to see that the sublease occurs. If the prime lease is not in default and the sublandlord is still occupying the premises, the overlandlord needs also to determine the likelihood that the operation will be closed down in the future and the space vacated, with the resulting effects on other tenants of the property (especially

in a retail situation). In a retail situation with percentage rent, the overlandlord will also need to determine how future economic performance of the sublandlord will affect the amount of percentage lease payments in the future. Financial statements, Dun & Bradstreet reports, credit reports, and bankruptcy searches can all be obtained and provide useful information for the overlandlord.

#### **B. Determine Financial Strength of Subtenant**

Once it knows the current strength of the sublandlord, the overlandlord then needs to determine if the financial strength of the proposed subtenant is acceptable, since with a failing sublandlord the subtenant may become the primary credit for the prime lease. Additionally, if the prime lease gives the overlandlord the right to receive any sublease rent in excess of prime lease rent, the overlandlord will want to determine the ability of the prospective subtenant to pay the sublease obligations. As an additional party to the lease situation overall, the new subtenant raises yet another prospect of a bankruptcy filing that could result in further loss of control by the overlandlord. Again, financial statements, credit reports, and other financial information regarding the subtenant may prove invaluable.

#### **C. Determine Whether Subtenant's Use Will Render Premises in Violation of Zoning and Land Use Requirements**

The new operations by a subtenant in the premises may lead to changes that affect the property's compliance with zoning and land use requirements, for which the overlandlord may be ultimately liable. This could result from a change in use, a change in the number of employees (affecting parking requirements), or the subtenant's desired alterations. With a sublease of only a portion of the premises, the addition of multiple parties using the space may cause even greater land use compliance problems. As discussed above in connection with the subtenant's checklist, ADA compliance is also a concern.

#### **D. Review Prime Lease to Determine Rights and Leverage of Overlandlord**

The overlandlord will need to refresh itself of the terms of the prime lease to determine its rights and leverage in dealing with the sublease approval process. Primary, of course, are the sublease provisions, which will state the level of consent required. The overlandlord will need to consider case law, which in a slight minority of jurisdictions implies that the overlandlord's consent cannot be unreasonably withheld, unless there is express language setting forth a stronger standard for consent. Universally, if the lease is silent on subleasing, subleasing is permitted without consent. The overlandlord will also need to look for provisions giving it the ability to recapture space in the given situation, the right to receive sublease rents in excess of prime lease rents, the right to prevent the subtenant's desired use, and the right to prevent the subtenant's requested alterations.

**E. Determine Ability to Make Representations and Warranties or Estoppel Statements Required by Subtenant**

The overlandlord who wants the sublease transaction to take place will need to conduct certain due diligence to enable it to issue the estoppel certificate that will be required. The overlandlord will know the key provisions that will be required: assuring that there are no lease defaults; confirming the terms of the lease; and verifying the status of rent payments. To do this, the overlandlord will need to make inquiry of its property managers, employees, and maintenance people, and review its leasing files.

**F. Obtain Contractual Agreement of Sublandlord to Pay Overlandlord's Expenses**

This item is a due diligence item only in the sense that the overlandlord needs to remember to seek an agreement of the sublandlord, or possibly the subtenant, to pay its expenses in connection with the review of the sublease situation and the cost of its due diligence. Prime leases rarely provide for this, but it could be requested in return for the overlandlord's consent.

**G. Determine the Authority and Ability of Parties to Be Contractually Bound**

As discussed for the subtenant and sublandlord, the prudent overlandlord will need to verify the authority of the subtenant to enter into the sublease. It is possible that the overlandlord may already have resolutions on hand with respect to the sublandlord; however, obtaining updated certificates of good standing for the sublandlord may be prudent.

#### **IV. CONCLUSION**

The inherent complexity of subleases makes them anything but a quick and easy exercise. The following checklists serve as a due diligence framework to make sure the assumptions and expectations of the parties to the sublease transaction are valid.

## APPENDIX 4.1

### Due Diligence Checklists

#### I. Subtenant's Due Diligence Checklist

- A. Review existing prime lease provisions to identify issues that could be problematic for subtenant and determine if they can be amended in overlandlord consent or in prime lease amendment.
  - 1. Landlord consent requirement to sublease
  - 2. Exclusivity provisions
  - 3. Use provisions
  - 4. Signage provisions
  - 5. Continuous operation requirements
  - 6. Percentage rent provisions that are unclear in sublease context
  - 7. Prohibition of sub-subleasing
  - 8. Consent requirements to further alterations
  - 9. Insurance—effect of additional layer of coverage, use of proceeds
  - 10. Casualty and condemnation proceeds
  - 11. Length of term
  - 12. Overlandlord recapture right upon attempted sublease
  - 13. Expense pass-throughs
  - 14. Parking (especially if partial sublease)
  - 15. Lack of overlandlord estoppel or representation requirements
  - 16. Damages and remedies
  - 17. Tenant responsible for compliance with laws; e.g., Americans with Disabilities Act
  - 18. Title to tenant improvements; ability to remove
- B. Determine physical condition of premises and expenses to be incurred in connection with condition.
  - 1. General property inspection
    - a. General physical condition of premises
    - b. Feasibility of desired alterations given existing tenant improvements
    - c. Remaining life and upgradability for subtenant needs of HVAC and other major systems
    - d. Shared facilities outside of subleased premises
    - e. Usefulness and condition of personal property included with sublease
    - f. Need for new direct access if partial sublease

2. Environmental inspection
  - a. Phase I update or new inspection
  - b. Indoor air quality
  - c. Sublandlord's files and inspection report review
  - d. Overlandlord's files and inspection report review (if possible)
- C. Determine compliance of premises with laws.
  1. Compliance of existing premises with zoning, land use, and building codes
  2. Compliance of existing premises with Americans with Disabilities Act and public accommodation standards
  3. Certificates of occupancy
  4. Compliance of tenant's anticipated alterations with governmental laws and regulations and with terms of lease
    - a. Building code
    - b. Americans with Disabilities Act
    - c. Local zoning and land use requirements: parking, signage, etc.
    - d. Overlandlord consent
    - e. Overlandlord's mortgagee consent
    - f. Sublandlord consent
- D. Confirm status of title ownership to real estate and personal property to be used by subtenant (title and UCC searches on overlandlord and sublandlord).
  1. Verify overlandlord fee ownership of real property and overlandlord or sublandlord ownership of personal property
  2. Verify existence of lien holders that may require consent
  3. Verify no other leases of premises of record
  4. Verify free of mechanic's or judgment liens
  5. Determine expiration date of overlandlord's financing (to indicate overlandlord's need for extension of lease term)
- E. Determine existence and status of service contracts affecting premises.
  1. In name of sublandlord or another party
  2. Terms of contracts
  3. Assignability to subtenant
  4. Verify no existing sublandlord defaults
- F. Determine whether prime lease could be terminated or could subject subtenant to unknown legal liabilities.
  1. Overlandlord's estoppel
    - a. No default of sublandlord
    - b. No disputes with sublandlord
    - c. No anticipated payments due from sublandlord for annual common area maintenance (CAM) or expense payment reconciliation
    - d. Identify all prior lease amendments
    - e. No violation of exclusives in overlandlord's other leases
  2. Sublandlord's estoppel
    - a. No default of overlandlord
    - b. No default of sublandlord

- c. No disputes with overlandlord
- d. Identify all prior lease amendments
- e. Sublease not a violation of other contractual obligations of sublandlord (other subleases, etc.)
- 3. Right of subtenant to pay rent directly to overlandlord, and/or subtenant notice and cure rights regarding prime lease defaults
- 4. Determine sublandlord's financial strength and likelihood of bankruptcy
- 5. Determine overlandlord's financial strength and likelihood of bankruptcy
- G. Determine authority and ability of parties to be contractually bound.
  - 1. Sublandlord's resolutions; review of organizational documents
  - 2. Sublandlord's certificate of good standing
    - a. Jurisdiction where organized
    - b. Jurisdiction of premises
  - 3. Overlandlord's resolutions; review of organizational documents
  - 4. Overlandlord's certificate of good standing
    - a. Jurisdiction where organized
    - b. Jurisdiction of premises
- H. Determine financial strength of sublandlord and overlandlord.

## II. Sublandlord's Due Diligence Checklist

- A. Determine financial strength of subtenant and (if possible) overlandlord.
  - 1. Ability to pay subtenant's rent obligations to overlandlord, any additional obligations to subtenant to sublandlord, and complete tenant improvements
  - 2. Likelihood of subtenant bankruptcy
  - 3. Future prospects of percentage rent (retail) (to satisfy subtenant's obligations to overlandlord)
  - 4. Likelihood of overlandlord bankruptcy
- B. Review prime lease to determine rights and leverage of sublandlord.
  - 1. Ability to sublease without consent or consent not unreasonably withheld; exception to consent requirement
  - 2. Use provisions
  - 3. Overlandlord ability to recapture space
  - 4. Financial covenants
  - 5. Overlandlord right to sublease rents in excess of prime lease rents
  - 6. Alterations provisions
- C. Determine ability to make representations and warranties or estoppel statements required by subtenant.
  - 1. "No lease defaults"—question on-site personnel regarding overlandlord defaults or disputes
  - 2. "No lease amendments"—check leasing files for amendment letters, work letters, commencement date letters, and existing estoppel certificates, including lender subordination, nondisturbance, and attornment agreements (SNDAs)

3. “Rent payments current”—check common area maintenance (CAM), tax, and insurance payments, and annual reconciliations
- D. Determine whether future activities of subtenant could render prime lease in default.
  1. Lease use provisions
  2. Lease alterations provisions
  3. Continuous operation and hours of operations covenants
  4. Signage requirements
  5. Compliance with governmental laws covenant
    - a. Use permitted under land use laws
    - b. Building codes and permits, tenant alterations
    - c. Parking requirements
    - d. Violation of Americans with Disabilities Act from change to public accommodation
- E. Determine authority and ability of subtenant to be contractually bound.
  1. Subtenant’s resolutions; review of organizational documents
  2. Subtenant’s certificate of good standing
- F. Determine status of existing service contracts.
  1. Obtain service provider’s consent to assignment and release of sublandlord’s liability for contracts subtenant wants to assume
  2. Terminate service contracts subtenant does not want

### III. Overlandlord’s Due Diligence Checklist

- A. Determine financial strength of sublandlord.
  1. Ability to continue to pay rent obligations
  2. Likelihood of bankruptcy
  3. Likelihood of going dark (if hasn’t already)
  4. Future prospects for percentage rent (retail)
- B. Determine financial strength of subtenant.
  1. Ability to pay rent obligations if sublandlord cannot pay; ability to pay rent in excess of prime lease
  2. Likelihood of bankruptcy
  3. Future prospects for percentage rent (retail)
- C. Determine whether subtenant’s use will render premises in violation of zoning and land use requirements.
  1. Change in use
  2. Change in number of employees (may affect parking)
  3. If partial sublease, possible effect from changing single-tenant space to multiple-tenant space (may affect parking)
  4. Effect of subtenant’s desired alterations
- D. Review prime lease to determine rights and leverage of overlandlord.
  1. Ability to withhold consent to sublease
  2. Ability to recapture space
  3. Right to sublease rents in excess of prime lease rents



4. Right to prevent subtenant's change in use
  5. Right to prevent subtenant's requested alterations
- E. Determine ability to make representations and warranties or estoppel statements required by subtenant.
1. "No lease defaults"—question on-site personnel regarding subtenant defaults or disputes
  2. "No lease amendments"—check leasing files for amendment letters, work letters, commencement date letters
  3. "Rent payments current"—check CAM, tax, and insurance payments, and annual reconciliation
- F. Obtain contractual agreement of sublandlord to pay overlandlord's expenses in connection with consent review, including legal fees (if not in prime lease).
- G. Determine authority and ability of parties to be contractually bound.
1. Subtenant's resolutions; review of organizational documents
  2. Subtenant's certificate of good standing
    - a. Jurisdiction where organized
    - b. Jurisdiction of premises
  3. Sublandlord's resolutions; review of organizational documents
  4. Sublandlord's certificate of good standing
    - a. Jurisdiction where organized
    - b. Jurisdiction of premises