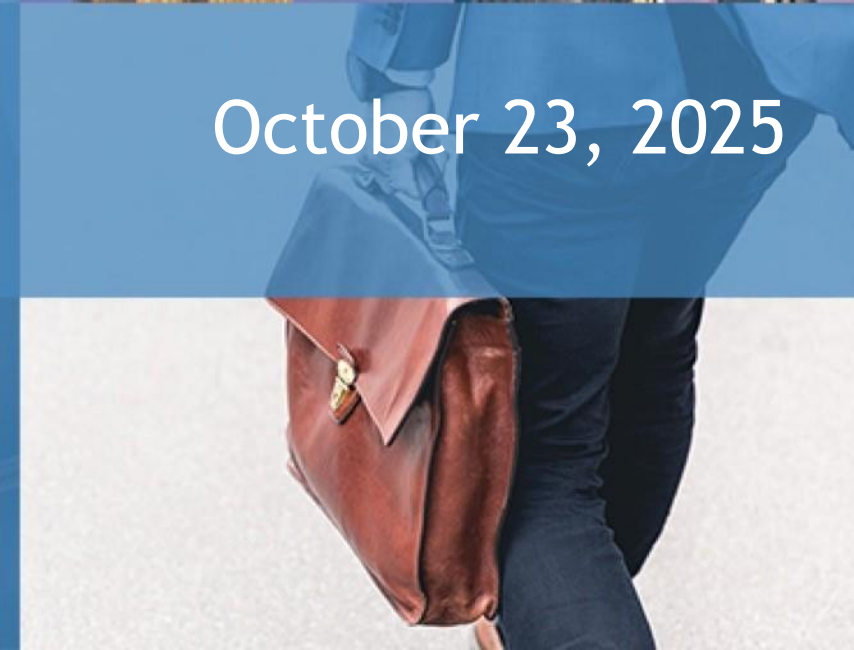


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COMMERCIAL LEASE ASSIGNMENTS AND SUBLEASES: POTENTIAL TRAPS AND PRACTICAL SOLUTIONS FOR TENANTS

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Agenda

Commercial Lease Assignments and Subleases

- Assignments & Subleases: The Basics
- Assignments & Subleases: Why It Matters
- Common Potential “Traps” in the Primary Lease
- Potential Tax “Traps” Arising From Landlord Actions
- Key Takeaways
- Q&A



Assignments & Subleases: The Basics

Assignments & Subleases: The Basics

- Assignment: transfer of the entire leasehold to a new tenant
 - Document: Assignment of Lease
- Subletting: transfer of less than the full interest (portion of premises or term); original lease still governs
 - Documents: Original Lease and Sublease
- Key similarity: Landlord consent is usually required
- Key difference: privity of contract and continuing liability



Assignments & Subleases: Why It Matters

Assignments & Subleases: Why It Matters

Goals in Negotiating Assignment & Sublease Clauses

LANDLORD	TENANT
Control over occupancy and use	Monetize the leasehold
Maintain credit quality and lease security	Maintain flexibility / exit strategy
Limit administrative burden and legal risk	Avoid hidden liabilities



Common Potential “Traps” in the Primary Lease

Assignments & Subleases: Potential “Traps”

- Consent Standard
 - sole discretion vs. reasonable
- Continuing Liability
 - tenant remains “on the hook”
- Bonus Rent
 - profit sharing
- Recapture Rights
 - landlord’s ability to take back the Premises
- Fees & Costs
 - legal and administrative review fees

Sample Assignment & Subletting Clause

Assignment and Subletting. Tenant shall not voluntarily or by operation of law assign, transfer, mortgage, sublet, license or otherwise encumber (collectively, “**Transfer**”) all or any part of Tenant's interest in this Lease or in the Premises without Landlord’s prior written consent.

Consent Standards

- “Sole discretion” vs. “Reasonableness” standard
 - “...without landlord’s prior written consent, which may be withheld in landlord’s sole discretion...”
 - “without landlord’s prior written consent, which shall not be unreasonably withheld, conditioned, or delayed...”

Consent Standards: Solutions for Tenants

- Timing requirements for landlord response
 - “Landlord shall provide response within 10 days...”
 - “Deemed consent” if no timely response
- Limit landlord’s ability to deny Tenant’s Transfer request
 - Insert the “reasonable” reasons why landlord may withhold its consent
- Definition of “Transfer”
 - Include “Permitted Transferee” language

Deemed Assignment due to Change of Control

- Mergers, reorganizations, and stock sales may be deemed as an assignment
- Risk for tenants: corporate growth, investment, or IPO could trigger defaults
- Solutions for tenants:
 - Carve-outs for affiliate transfers (Permitted Transferees), internal reorganizations, IPOs
 - Narrow the definition to true transfers of control

Continuing Liability of Original Tenant

“Regardless of Landlord’s consent, no transfer shall release Tenant of Tenant’s obligations hereunder or alter the primary liability of Tenant hereunder.”

Continuing Liability of Original Tenant

- Subleases: due to privity, original tenant will remain liable to landlord
- Assignments: depending on the language, original tenant will remain liable after assignment, and risk being dragged back into disputes years later
- Solutions for tenants:
 - Negotiating releases or burn-off provisions
 - Limit liability to rent obligations, not all covenants

Bonus Rent / Profit Sharing

“Profit Sharing. In connection with any Transfer, Tenant shall pay to Landlord one hundred percent (100%) of the excess payable by Transferee over and above the Rent due and payable under this Lease, including, but not limited to, key money and bonus money paid by the Transferee to Tenant in connection with any Transfer, and any payment in excess of fair market value for services rendered by Tenant to Transferee or for assets, fixtures, inventory, equipment, or furniture transferred by Tenant to Transferee in connection with such Transfer. Together with such payment, Tenant shall give Landlord a detailed statement of all consideration Tenant either has or will derive from such Transfer, and the calculation of the amounts due Landlord under this Paragraph.”

Bonus Rent / Profit Sharing

- Tenant expectation: realize the value of below market rents
- Landlord expectation: capture “excess rent” from Transfers
- Strategies for Tenants
 - Limit to a lower percentage (50%)
 - Carve out transfers to a Permitted Transferee
 - Deduct brokerage, TI, concessions, free rent, and legal fees
 - Clarify profits tied to the sale of Tenant’s business /goodwill are excluded

Recapture Rights

“Recapture of Premises. Landlord shall have the option, after receiving written notice of any proposed assignment or sublease from Tenant (a "**Transfer Notice**"), to terminate this Lease and recapture the space which is the subject of such proposed transfer (the "**Subject Space**"), in which event this Lease shall automatically terminate on the thirtieth (30th) day after Landlord so notifies Tenant (the "**Termination Date**") with the same force and effect as if said Termination Date had been designated as the expiration date of this Lease.”

Strategies for Tenants

- Request to strike altogether
- Carve out transfers to “Permitted Transferees” and for internal restructuring
- Insert a timeframe for landlord to exercise this recapture right
- Include right to rescind the transfer request

Fees & Costs

“Expenses. Tenant shall pay all of Landlord's costs incurred in reviewing and processing a request for an assignment or sublease. Landlord's costs shall include all legal review fees and expenses, and all direct and indirect expenses incurred by Landlord arising from any assignee or sublessee taking occupancy in the Building (including the costs of all additional security, janitorial, cleaning, and trash removal services).”

Fees & Costs

- Hidden expenses
 - landlord's attorneys' fees, administrative fees, processing fees
 - can make Transfers uneconomical
- Strategies for Tenants
 - Negotiate a cap on fees
 - Require “reasonable” fees only



Potential Tax “Traps” Arising From Landlord Actions

California Property Tax: Change in Ownership and Reassessment

Proposition 13

- Overview
- Examples of Change in Ownership
 - A transfer to a third party via deed
 - The creation or termination of a 35-year lease, subject to certain exceptions.
 - A transfer of property to or from a legal entity, subject to certain exceptions.
 - Transfers of interests in a legal entity, subject to certain exceptions.

NOTE: This overview of Proposition 13 is intentionally abbreviated for purposes of discussing a potential trap for tenants in commercial leases. A full discussion of Proposition 13 requires a separate presentation.

California Property Tax: Change in Ownership and Reassessment

Property Tax Rule 462.100(a) – Change in Ownership - Leases

The following transfers result in a Change in Ownership:

(1) Lessee's Interest:

- (A) the creation of a leasehold interest in real property for a term of 35 years or more.
- (B) the transfer, sublease, or assignment of a leasehold interest with a remaining term of 35 years or more.
- (C) the termination of a leasehold interest which had an original term of 35 years or more.

(2) Lessor's Interest:

(A) The transfer of a lessor's interest in taxable real property subject to a lease with a remaining term of less than 35 years.

(B) The transfer of a lessor's interest in taxable real property subject to multiple leases, one or more of which is for a remaining term of less than 35 years and one or more of which is for a remaining term of 35 years or more, in which case there is a change in ownership of the portion of the property subject to the lease(s) with a remaining term of less than 35 years.

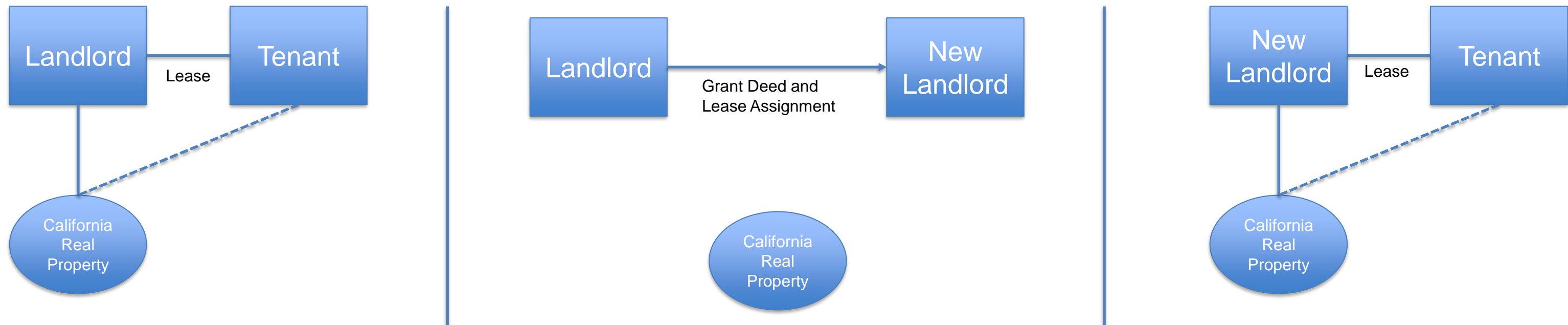
Note: The calculation of the term of a lease for all purposes of Property Tax Rule 462.100 shall include written renewal options.

California Property Tax: Change in Ownership and Reassessment

Property Tax Rule 462.100(a)(2)(A): The transfer of a lessor's interest in taxable real property subject to a lease with a remaining term of less than 35 years.

Hypo 1:

- 20-year NNN lease
- Landlord sells property to third party

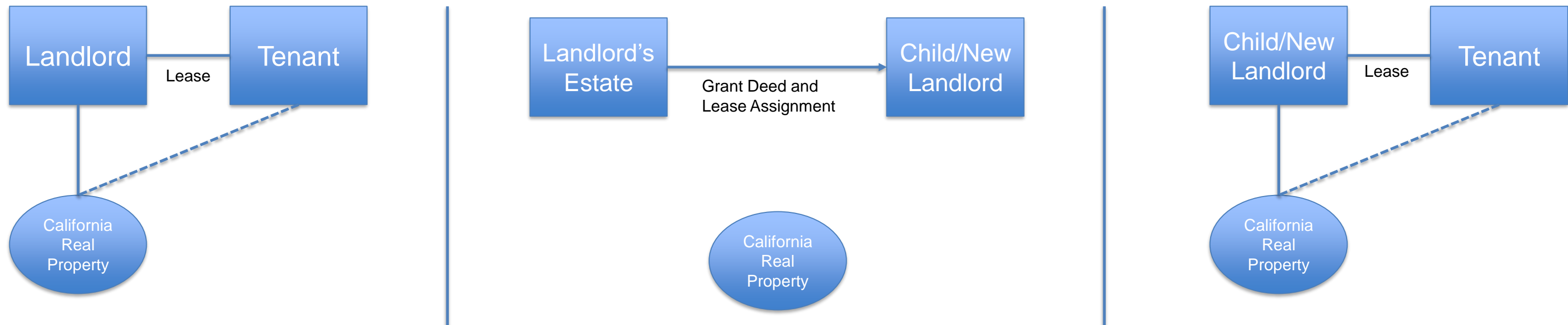


California Property Tax: Change in Ownership and Reassessment

Property Tax Rule 462.100(a)(2)(A): The transfer of a lessor's interest in taxable real property subject to a lease with a remaining term of less than 35 years.

Hypo 2:

- 20-year NNN lease
- Landlord dies and property passes to child



California Property Tax: Change in Ownership and Reassessment

California Revenue and Taxation Code Section 64(c)(1):

“When a corporation, partnership, limited liability company, other legal entity, or any other person obtains control through direct or indirect ownership or control of more than 50 percent of the voting stock of any corporation, or obtains a majority ownership interest in any partnership, limited liability company, or other legal entity through the purchase or transfer of corporate stock, partnership, or limited liability company interest, or ownership interests in other legal entities, including any purchase or transfer of 50 percent or less of the ownership interest through which control or a majority ownership interest is obtained, the purchase or transfer of that stock or other interest shall be a change of ownership of the real property owned by the corporation, partnership, limited liability company, or other legal entity in which the controlling interest is obtained.”

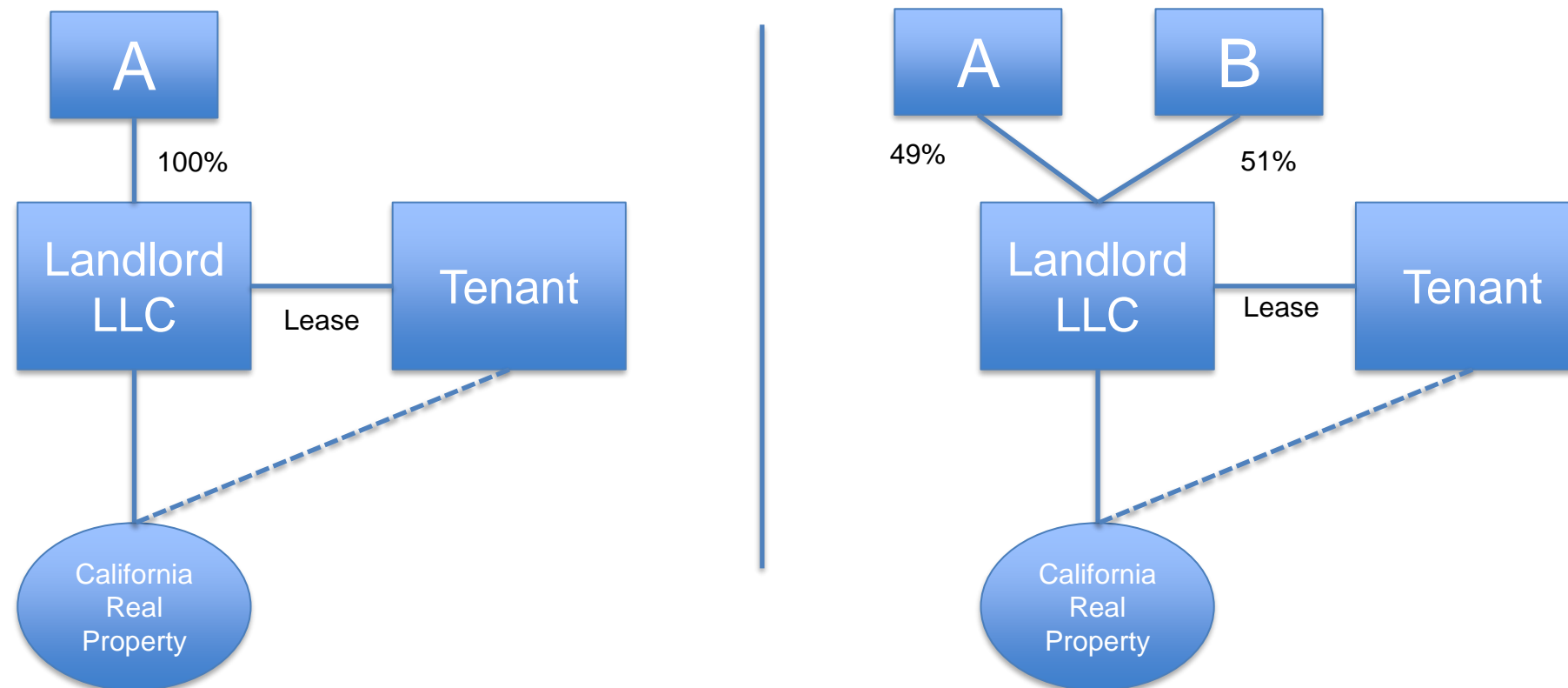
Key takeaway: When someone new comes into control of a legal entity holding California real property, such property undergoes a change in ownership.

California Property Tax: Change in Ownership and Reassessment

Change in Control of Landlord under RTC Section 64(c)(1): Someone new acquires more than 50% of the capital and profits of Landlord LLC.

Hypo 3:

- 20-year NNN lease
- Landlord entity admits a 51% new member

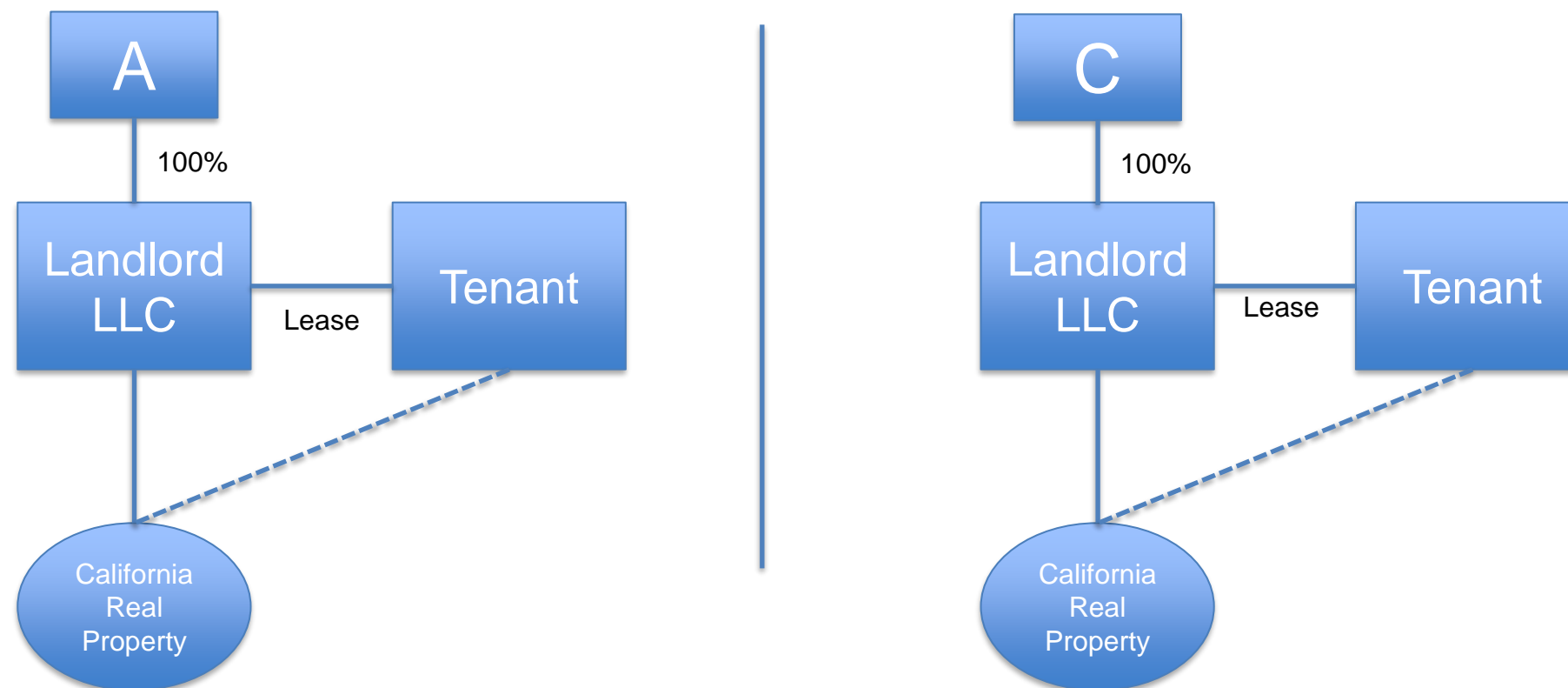


California Property Tax: Change in Ownership and Reassessment

Change in Control of Landlord under RTC Section 64(c)(1): Someone new acquires more than 50% of the capital and profits of Landlord LLC.

Hypo 4:

- 20-year NNN lease
- Sole member of landlord entity dies and 100% interest in landlord entity passes to child



California Property Tax: Change in Ownership and Reassessment

Common Tax Provision in Commercial/Industrial Leases: Commencing on the Lease Commencement Date, for each Tax Year within the Term, Tenant shall pay to Landlord in accordance with this Section, as Additional Rent, an amount equal to Tenant's Proportionate Share of all Real Estate Taxes for that Tax Year.

Real Estate Taxes: Landlord and Tenant acknowledge that the voters of the State of California adopted Proposition 13 in the June 1978 election ("Proposition 13") and intend that Real Estate Taxes include any increases in real estate taxes, assessments, levies, fees, or charges resulting from a reassessment caused by, or attributable to, a change in ownership of the Project, or any portion thereof, new construction with respect to the Project, or any portion thereof, or any other cause under Proposition 13.

NOTE: The above example is an excerpt from a tax provision available in Practical Law and is included for purposes of illustrating a potential trap for tenants.

California Property Tax: Change in Ownership and Reassessment

Example of Proposition 13 Protective Provision:

Real Estate Tax Exclusions. Notwithstanding anything to the contrary contained in this Lease, Real Estate Taxes shall specifically exclude:

- Any increases in Real Estate Taxes resulting from a reassessment caused by, or attributable to, a change in ownership of the Project, or any portion thereof, new construction with respect to the Project, or any portion thereof, or any other cause under Proposition 13 ("Proposition 13 Exclusion"); provided, however, Tenant shall be liable for the regularly scheduled annual increases in Real Estate Taxes. [This Proposition 13 Exclusion is personal to the Tenant originally named in this Lease and, notwithstanding anything to the contrary contained elsewhere in this Lease, may not be assigned or transferred by the Tenant originally named in this Lease to any other person or entity.]

NOTE: The above example is an excerpt from a tax provision available in Practical Law and is included for purposes of illustrating a potential solution for tenants.

California Property Tax: Change in Ownership and Reassessment

Tips and Reminders for Tenants:

- Change in ownership events can occur in a variety of ways and can significantly affect an unsuspecting tenant who is responsible for all property tax increases under its lease.
- It is best to address Prop 13 protection during the Letter of Intent phase of the lease negotiation process.
- Watch out for tax provisions that do not address Prop 13 specifically and are overly broad.
- Work with tax counsel who can review the boilerplate tax provisions carefully and negotiate protections for tenants.
- Other tax traps can arise in tenant assignment and sublease agreements.

Key Takeaways

Key Takeaways

- Negotiating the assignment and sublease provisions in lease is critical for flexibility
- Don't rely on "boilerplate" language
- Proactive drafting prevents liability and preserves value
- Attorneys can help tenants negotiate practical, balanced solutions
- Without limiting the broad reach of the boilerplate provisions in a lease, a tenant can be exposed to unforeseen costs

Q&A



Follow Up

Feel free to reach out to us with any additional questions:

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