

## SUBTENANTS: PROTECTING YOUR LEGAL STATUS

*(To the reader: Please note that many of the legal references and analysis below are specific to the laws of the province of Ontario. If you require further information specific to your jurisdiction, please communicate with one of our commercial real estate group coordinators in your region, as listed below.)*

Given the downturn in the economy and the resulting downsizing by many companies, the commercial leasing market will likely experience an increase in available subleased premises. While this influx could potentially represent an economic windfall, potential subtenants need to be aware of their legal status with respect to their sublet premises prior to signing their sublease.

By the very nature of the tri-party relationship, subtenants are exposed to the risk of having their right to sublease the premises automatically extinguished as a result of the head lease for the premises being terminated. In most circumstances, the sublease is dependent upon the head lease and cannot exist without it. Accordingly, to off-set this risk of early termination, a subtenant needs to be cognizant of existing statutory protections and diligent in negotiating protections in his sublease..

### Limiting Risks of Early Termination

Although it is difficult for a subtenant to completely protect its sub-tenancy, there are ways to minimize the risk of early termination:

#### (1) Contractual Accommodation by the Landlord

Ideally, a subtenant can successfully negotiate a guarantee from the landlord so as to allow the subtenant continued occupation of its premises on the same terms and conditions as in the sublease in the event the head lease is terminated. However, landlords are often reluctant to provide such a guarantee without some incentive for the concession.



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On the other hand, a landlord will often agree to a reasonable notice provision by which a subtenant must leave the premises upon termination of the head lease. While not ideal, this provision gives the subtenant the time required to either negotiate a new lease directly with the landlord or find other premises with minimized disruption to its business.

## (2) Statutory Protection

The Ontario *Commercial Tenancies Act*, rso 1990, c.L.7 (the "CTA") also provides two significant statutory rights and protections to subtenants who are affected by a tenant's breach of a head lease.

(i) Pursuant to **Section 21** of the CTA, a subtenant may apply to Court for an order allowing it to retain the premises in the event the landlord terminates the head lease. The Court is given discretion regarding which terms should apply to this continuing tenancy. To date, courts have normally imposed the terms of the head lease on the subtenant so as to not unfairly affect the landlord in making decisions under this section.

(ii) **Section 39(2)** of the CTA provides for similar protection when a head lease is disclaimed or assigned by a trustee in bankruptcy. In this situation, the subtenant may normally assume the head lease at the rental rate that is the greater of (a) the rent paid by the tenant under the head lease and (b) the rent paid by the subtenant under the sublease. Nevertheless, the Court still maintains the right to change the terms of the lease.

In most circumstances, landlords will require subtenants to waive their statutory rights and protections found in sections 21 and 39(2) of the CTA as a condition of granting the subleases. While subtenants will try to resist such waivers, landlords will be reluctant to negotiate or modify the subleases' waiver clauses in order to protect their rights to terminate the sublease and access the entire premises where the tenant has declared bankruptcy or has otherwise breached the head lease.

## Limiting Risks of Statutory Waivers

Where a landlord insists that the sublease include a waiver of sections 21 and 39(2) of the CTA, the associated risks to the subtenant's quiet enjoyment of the sublet premises can be limited as follows:

**(1) Notice of Head Tenant Default.** The subtenant can negotiate that the sublease include a provision whereby the landlord agrees to provide the subtenant with written notice of any default by the tenant under the head lease together with a right to cure the breach within a reasonable period of time. The subtenant is then given the ability to keep the head lease in good standing or to negotiate a new lease directly with the landlord.

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**(2) Direct Payment of Rent to Landlord.** The subtenant can negotiate that the rent payable pursuant to the terms of the sublease be paid directly to the landlord, thereby reducing the risk of any potential diversion of funds away from the landlord and increasing goodwill between the landlord and subtenant.

**(3) Financial Security from Head Tenant.** As a condition of executing the sublease, the subtenant may require the tenant to post financial security to be used in the event the head lease is terminated as a result of tenant default or bankruptcy. The amount of this security should equal the reasonable costs necessary for the subtenant to relocate to new premises.

## Subtenant Due Diligence

While a carefully crafted sublease goes a long way to protect a subtenant's legal status in the tri-party relationship, it is equally important for the tenant to perform its due diligence prior to entering the sublease arrangement. Accordingly, the subtenant should:

- (i) analyse all the agreements that make up the head lease (i.e. the head lease itself and any amendments, estoppel certificates, non-disturbance agreements and any additional covenants and restrictions) and ensure the sublease will not be subject to a problematic head lease;
- (ii) ensure the tenant has sufficient financial strength to perform its obligations under the head lease;  
and
- (iii) ensure a non-disturbance agreement has been granted to the tenant pursuant to the terms of the head lease.

Current economic conditions will likely result in an opportunity to sublease premise at a reduced rental rate. However, potential subtenants need to be mindful of the legal and practical pitfalls of the tri-party relationship created by a "boilerplate" sublease. Like all agreements, the sublease needs to be crafted to satisfy the needs of the parties involved. Therefore, potential subtenants should consult with a lawyer before entering into any sublease transaction.

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