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Sublease Recognition Agreements

The following article is an abbreviated version of a presentation made by Norman Gutmacher to the American College of Real Estate Lawyers.

Sublease Recognition Agreements Generally

Sublease Recognition Agreements, also known as Direct Recognition Agreements ("Recognition Agreements"), are usually agreements between a ground lessor/fee owner of property (the "Owner") and a subtenant (the "Subtenant") under a sublease of all or part of the property (the "Sublease") that is the subject of the ground lease or over-lease (the "Prime Lease"), whereby the Owner agrees to recognize and honor the Sublease if the Prime Lease terminates due to the default by the tenant/ sublandlord under the Prime Lease not caused by the Subtenant.

The Subtenant is typically the party that should request or require a Recognition Agreement from the Owner when negotiating a Sublease, because the Subtenant will want to protect options to renew, options to purchase and other rights if, for whatever reason, the Prime Lease is breached by the tenant/sublandlord under the Prime Lease or the Prime Lease otherwise terminates.

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Anticipating this, a tenant of a large space or of an entire building may want to attempt to negotiate a provision into the Prime Lease whereby the Owner prospectively agrees to enter into a Recognition Agreement with a future, to be determined, Subtenant with respect to a future, to be negotiated, Sublease for all or a part of the premises.

When dealing with a significant Prime Lease, the Owner may also find it to be in its interest to enter into Recognition Agreements with each Subtenant so as to establish privity of contract between the Owner and each Subtenant and thereby enable the Owner to preserve each Sublease if one or more of the original tenants (i.e., one or more of the sublandlords) defaults under the Prime Lease and the Subtenant(s) of the defaulting sublandlord(s) would otherwise be in a position to terminate their respective Sublease(s).

If a Recognition Agreement becomes effective upon the termination of the Prime Lease by reason of a breach of the Prime Lease by the tenant/ sublandlord, then the Sublease effectively replaces and supersedes the Prime Lease (as to that portion of the original premises covered by the Prime Lease) for the duration of the Sublease. Therefore, the Owner must carefully analyze both the Sublease and the Subtenant prior to entering into a Recognition Agreement.

Recognition Agreements – The Entire Originally Demised Premises

If the Sublease that will be the subject of a Recognition Agreement is for the entirety of the premises that is the subject of the Prime Lease, then the Owner's review is relatively simple. The Owner can review both the Sublease and the proposed Subtenant by asking: Would it, in the role of a landlord, enter into the same Sublease if the premises were vacant?

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Recognition Agreements – Less Than the Entire Originally Demised Premises

Alternatively, if the Sublease is for only a part of the original premises, the Owner's review, by necessity, becomes more complex. In such a case, the Owner and its counsel must consider a variety of issues, both "legal" and "business," over and above the financial strength and experience of the Subtenant, including:

1. Is the Subleased space self-sufficient and self-contained, or does it have shared utilities or shared facilities with the balance of the space previously subject to the Prime Lease that is not subject to the Sublease and included in the subleased space?
2. Is the balance of the space that is not subject to the Sublease of a size and configuration so as to be readily leaseable at all, or only after substantial construction?
3. Does the balance of the space, not subject to the Sublease, have sufficient frontage?
4. Does the balance of the space, not subject to the Sublease, have necessary access for storage and deliveries and to the common areas, restrooms, and other important areas?
5. Are there any restrictions or exclusives in the Sublease that would apply to other properties of the Owner?
6. Does the Subtenant have self help, cancellation, set off or other rights that are inconsistent with the Prime Lease?
7. Will the business to be conducted by the Subtenant be compatible with replacement tenants for the balance of the Prime Lease space?
8. What are the obligations to rebuild the subleased space in the event of damage, destruction or condemnation of all or any part of the original demised premises?
9. Does the Sublease "require" that the sublandlord, at the option of the Subtenant, exercise one or more options to extend the term of the Prime Lease; and, if so, what impact might this have on the Owner's ability to lease the balance of the original demised premises?
10. Is the rent payable under the Sublease gross or net; and if gross, will the Owner effectively be providing free utilities or other services that were the obligation of the sublandlord to pay as tenant under the Prime Lease?

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All Recognition Agreements

As Mark Felt allegedly told Woodward and Bernstein when they began investigating Watergate, the first thing that a party should do is "follow the money." When requested to enter into a Recognition Agreement, an Owner initially will want to verify who will pay for its costs and expenses arising out of its review and negotiation of the Recognition Agreement. Not only is it likely that the Owner will incur significant legal costs on account of its own counsel, but the Owner may also be obligated to pay the costs and expenses of its lender. Even if the Sublease does not apply to the entirety of the originally leased premises under the Prime Lease, the Owner's mortgage loan documents may require the Owner to obtain the consent of its lender to enter into the Recognition Agreement.

Continuing in the "follow the money" vein, the Owner will also want to make certain that it will not be responsible to return any security deposit unless it had been received by the Owner.

Subtenants should consider whether, in addition to a Recognition Agreement, Owners should be asked to obtain a non-disturbance agreement from the Owner's lender. This protects the Subtenant if there is a mortgage default by the Owner. If applicable, the requirement of a non-disturbance agreement with the Owner's lender should be included as a provision in the Recognition Agreement.

Recognition Agreement Provisions in the Prime Lease

Increasingly, sophisticated tenants and those leasing entire buildings or large spaces are seeking to include a provision in the Prime Lease requiring the Owner to enter into a Recognition Agreement with any Subtenant. The Sublease provisions covering this topic can be relatively simple, or very complex.

Where the provision prospectively requiring a Recognition Agreement is in the Prime Lease, the Owner will not know who will be a subtenant, may not know which part of the original premises will be subleased, and will not have seen the Sublease. In this situation, the Owner will generally favor a complex provision in the Prime Lease to attempt to set the parameters of any subleasing arrangement so as to reduce its risks. Similarly, if the form of Recognition Agreement is to be attached to the Prime Lease, the Owner will generally be better served with a complex form of Recognition Agreement to reduce the risk of dealing with a future unknown subtenant.

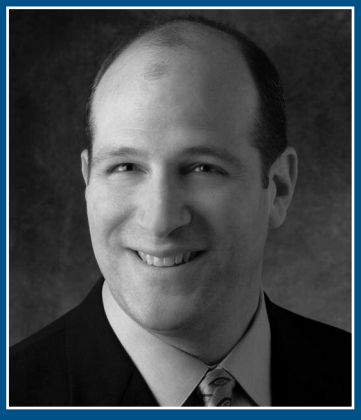
Conclusion

Subtenants of significant spaces should carefully consider whether or not a Recognition Agreement should be obtained as a precondition to subleasing space; particularly where there may be a question as to the continuing viability of its sublandlord; otherwise, the Subtenant may find itself without the subleased space or at the mercy of the Owner if the sublandlord defaults under the Prime Lease.

An Owner, if requested to enter into a Recognition Agreement, should be prepared to spend significant time to have a thorough understanding of the project and must carefully analyze the possible consequences if the Sublease were to replace the Prime Lease.

For more information on this topic, please contact Norman W. Gutmacher at ngutmacher@bfca.com or 216.363.4591.

Get to Know **Kevin Margolis...**



Who: Kevin Margolis is a partner and Chair of the firm's Real Estate and Environmental practice group. He focuses his practice on the environmental aspects of business, commercial lending, and real estate transactions and financing. Kevin is a member of the firm's Diversity Initiative Committee and Chair of the firm's Hiring Committee. He spends much of his time solving complicated environmental problems affecting real estate and corporate transactions, and on the redevelopment of "brownfields". Kevin is an author of the American Bar Association's book, *Brownfields: A Comprehensive Guide to Redeveloping Contaminated Property*. Currently, he is working on the financing and sale of several large contaminated properties in Ohio that will be redeveloped into exciting new residential, commercial and industrial projects.

What Kevin wants you to know about the Real Estate Industry: Currently, there are many more effective legal tools to solve environmental problems affecting real estate than ever before. The fear that was in the marketplace several years ago in connection with these issues has dissipated so that traditional real estate developers, with good advisors, can tackle these problem properties and solve these problems turning lemons into lemonade.

When Kevin is not practicing law: He spends time with his wife, Sheila, his children, Brian and Kaitlyn, and dogs, Yogi and Archie. He attempts to get a round of golf in here and there, if he can. He is on the board of Agnon School and on the board of The Temple-Tifereth Israel.

Ohio Mechanics' Lien Law and Leases

To secure payment to persons who furnish labor or materials, or both, for the improvement of real estate, Ohio's Mechanics' Lien Statute (the "Statute") creates a lien in their favor upon both the subject real estate and the improvements undertaken to such real estate. Potential claimants must have furnished the labor or materials pursuant to a contract with the holder of an interest in the real estate (or pursuant to a lower-tier subcontract under a contract with the interest holder) in order to avail themselves of the Statute. Further, the claimant must satisfy certain statutory requirements to preserve and perfect its mechanics' liens rights. A failure to observe any one of the statutory requirements will result in an invalid mechanics' lien. A valid mechanics' lien, however, will permit an unpaid claimant to foreclose upon the real estate and the improvements and have them sold at sheriff's sale (among other available remedies) to satisfy its claim.

Despite the potentially serious consequences of a mechanics' lien claim, landlords often give short shrift to mechanics' lien issues when dealing with tenant improvements. This lax approach may be the result of the "conventional wisdom" in Ohio which holds that because a mechanics' lien attaches only to the interest of the person who contracted for the improvements, a mechanics' lien arising from work performed pursuant to a contract with a tenant will be dissolved upon termination of the tenant's leasehold estate. This conventional wisdom, which is based upon not only an overly broad reading of a single, forty-year old Ohio Supreme Court decision, but also upon a failure to appreciate the nuances of the significant revisions to the Statute undertaken in 1991, is wrong.

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Ordinarily, when an improvement is made to real estate, the improvement becomes a part of the real estate itself. For purposes of the Statute, however, the real estate and the improvement retain their separate identities apart from each other. Thus, under the Statute, a mechanics' lien attaches not only to the contracting person, *i.e.*, tenant's, interest in the real estate, but also to *all* the interests, *i.e.*, tenant and landlord's interests, in the improvements made to the real estate. Therefore, when a tenant makes improvements to its landlord's real property, the landlord runs the risk that the tenant's failure to pay for such improvements will result in a mechanics' lien being recorded against not only the tenant's interest in the *real estate* and *improvements*, but also the landlord's interest in the *improvements*. Simply put, the termination of a tenant's leasehold interest will terminate the mechanics' lien against the tenant's interest in the real estate and the improvements which would become the landlord's property upon the lease's expiration or earlier termination, but will not terminate the mechanics' lien against the landlord's interest, if any, in the improvements. Accordingly, unless the landlord intends to receive a vanilla shell upon the lease's expiration or earlier termination, it is in the landlord's interest to protect its investment by preventing or, in the worst case scenario, discharging mechanics' liens recorded by its tenant's contractors or suppliers. Beyond that, the landlord's lender will likely take a dim view of other, non-tax liens attaching to its collateral, particularly if the mortgage secures a construction loan.

Fortunately, there are several provisions which landlords can include in their leases to address and mitigate the potential risk of mechanics' liens claimed by their tenant's contractors and suppliers. The balance of this article will briefly address some of these measures.

First, the lease should expressly state that the only relationship between the parties is that of landlord and tenant and that the lease does not create a partnership, agency or joint venture relationship between them. Such a provision can be useful in the event a tenant's contractor or supplier argues that the tenant acted on the landlord's behalf and, therefore, the landlord's interest in the real estate (in addition to the landlord's interest in the improvements) is subject to its mechanics' lien claim.

Second, the lease should require that the tenant's construction agreement with its contractors include a no-lien provision whereby the tenant's contractors agree (a) to waive *all* of their mechanics' lien rights; and (b) to require their lower-tier subcontractors to waive all of their mechanics' lien rights as well. Although no-lien provisions are unenforceable in some states, Ohio's legislature has not, as yet, deemed them void and at least one Ohio court of appeals has upheld the enforceability of a no-lien provision.

Third, the recording of a mechanics' lien by one of the tenant's contractors or lower-tier subcontractors should constitute an event of default under the lease. The remedies available to the landlord should include the right, at its option, to (a) satisfy the lien by payment directly to the lien claimant; or (b) discharge the lien by furnishing a bond or other substitute security for the claim. However, in the interest of the landlord and tenant's long term business relationship and in recognition of the fact that the tenant may have a legitimate dispute with its contractor or supplier, the landlord should refrain from pulling the rug out from under the tenant by paying the lien amount directly to the claimant and simply adding that amount to "additional rent." Direct payment all but eliminates any leverage the tenant may have to resolve a dispute with its contractor. A less draconian response would be to bond the lien off of the real estate and improvements and add that cost to additional rent. Bonding the lien will remove it from the real estate and improvements, yet will not eliminate the tenant's leverage to resolve any dispute with its contractor or supplier. Along these same lines, landlords should consider giving the tenant an ample amount of time to cure this type of default before the landlord avails itself of the foregoing remedies. In the final analysis, however, the landlord's response must be driven by the effect of the lien's recording upon its own obligations under its mortgage or its efforts to refinance or sell the property.

Lastly, the landlord should require the tenant to record a notice of commencement ("NOC") and to otherwise proceed with the improvements in accordance with the Statute. Recording an NOC requires contractors to serve a notice of furnishing ("NOF") upon certain statutorily enumerated parties in order to preserve its mechanics' lien rights. If a contractor fails to serve a proper NOF or fails to serve the NOF upon all the required parties, it forfeits its mechanics' lien rights. Very often, a potential mechanics' lien claim is short-circuited when the contractor is made aware that it failed to fulfill its NOF obligations.

The foregoing list is far from exhaustive. Nor are the remedies available to a lien claimants limited to foreclosure. Indeed, under the Statute, the lien claimant could become your new tenant notwithstanding the lease's prohibitions against assignment by operation of law. But, that is a topic for a future issue. For now, be aware that although mechanics' liens recorded by a tenant's contractors or suppliers can have serious implications for a landlord, there are number of practical measures a landlord can take to mitigate, if not eliminate, the risks.

For more information on this topic, please contact Gary G. Yashko at gyashko@bfca.com or 614.223.9337.

2006 International Council of Shopping Centers Spring Convention

The retail real estate industry is enjoying rapid growth and profitability in all sectors, as evidenced by the 45,000 attendees at the **2006 International Council of Shopping Centers Spring Convention** in May. Norman Gutmacher, Kevin Margolis, Mike Swearengen, and Jeff Wild, partners in Benesch's Real Estate Group, attended the conference and hosted dinners for clients and friends who were in attendance. Some of the hot topics at this year's conference revolved around lifestyle centers, retail opportunities in the urban core, and retail's role in mixed-use development.

Attending the ICSC Convention helps Benesch's Real Estate Team stay on top of the cutting edge of retail real estate development trends. The group also networked with national and regional developers, national tenants, lenders, and other sources of capital.

Benesch works with clients on retail real estate development projects they are pursuing across the country.

Recent Client Engagements

Some of our recent client engagements include representing:

- the Greater Cleveland Regional Transit Authority in connection with real estate matters associated with the Euclid Corridor Transportation Project, an approximately $168 million project involving improvements to the public transportation infrastructure and the redevelopment of over 7 miles of roadway in the heart of Cleveland.
- a publicly-held REIT in the assemblage of over 130 acres of vacant land in connection with the proposed development of a retail shopping center.
- a publicly-held REIT with respect to the acquisition of a joint venture partner's membership interests in a large shopping center development.
- a property owner in connection with a $6 million refinancing of a retail shopping center.
- a manufacturing company with respect to the purchase of adjacent property in order to expand operations, as well as obtaining a $6.3 million construction loan to facilitate the land acquisition and construction.
- owner of large manufacturing facility in negotiating the sale of property and the assumption of specific environmental clean-up obligations by the buyer.
- several large manufacturing companies with respect to superfund claims by the U.S. Environmental Protection Agency and third parties.
- a property owner in the negotiation of more than a 50% reduction in the civil penalty proposed by the U.S. Environmental Protection Agency relating to waste handling practices on the property.
- a publicly-held REIT in the disposition of numerous shopping centers located throughout the United States.
- a lender in the acquisition of a 15-story apartment/mixed-use property by deed-in-lieu of foreclosure of a $32 million mortgage.
- a national bank in connection with all real estate matters relating to the issuance of letters of credit in excess of $25 million to support the bond financing of senior care, nursing home, and assisted living facilities.
- a national bank in connection with all real estate matters relating to a $16.5 million credit facility.
- a mezzanine lender in connection with a $1.2 million bridge loan.
- a national bank in connection with a construction loan in excess of $4 million to finance the land acquisition and construction of a drugstore.
- a private equity firm acquiring a manufacturing business with multiple locations (domestic and international), some with significant environmental issues.

For more information about our Real Estate & Environmental Practice Group, please contact one of the following:

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