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What to Consider When Your Tenant Wants a Lease Modification

As people return to work in office buildings following the COVID-19 stay-at-home orders, tenants may be envisioning a new normal — one in which fewer people come into work at any particular time, less office space is needed due to downsizing or more work from home opportunities, or the office space needs to be physically altered to allow for social distancing. In this new normal, landlords may be requested to modify existing leases prior to their full term.

How can landlords balance the changing needs of tenants with the economic realities of needing to have the space leased? Landlords will want to consider the following options to keep current tenants intact or reduce the financial ramifications if the tenant needs to step back from its current office footprint.

Assignment or Sublease of Existing Lease

One option is for a landlord to agree to assign the space to a new tenant under the existing lease.

Leases normally require that a tenant obtain the consent of the landlord in order to assign the lease. An assignment of the lease provides for a direct relationship between the landlord and the new tenant and the old tenant normally remains liable under the terms of the lease, but that can be subject to negotiation.

A landlord can also agree to assign a portion of the space to a new tenant. Such a situation would deviate from the norm, as most leases do not provide for partial assignments as landlords do not typically want to have additional tenant responsibilities.

The items that a landlord will want to consider in consenting to an assignment vary depending upon the terms of the lease or the items requested by the landlord.

Overall, a landlord will want to review the financial condition and previous business experience of the new tenant to evaluate whether the new tenant will abide by the terms of lease, namely payment of rent and other obligations. A landlord may condition an assignment upon the previous tenant (and guarantor, if applicable) remaining liable under the terms of the lease, in addition to the new tenant's liability.

This would enable the landlord to have multiple sources of relief in the event that the new tenant does not timely pay the rent obligations. Also, a landlord may require that the new tenant provide a separate guarantor to guaranty the lease obligations. To cover the administrative and legal costs for reviewing such assignments, a landlord may want to consider assessing an administrative fee or reimbursement for the out-of-pocket expenses related to the assignment that the tenant will have to pay in order to have the assignment reviewed and analyzed by the landlord and its related professionals.

Much like an assignment of the lease, a landlord can agree to a sublease of all or part of the space to a new tenant. Under a sublease, the new subtenant enters into an agreement with the existing tenant rather than directly with the landlord. The existing tenant remains liable to the landlord for all of the lease obligations.

Ultimately, the big difference lies with the party responsible for collecting the subtenant's rent, which is the current tenant. The considerations for a landlord when analyzing whether to grant a sublease are substantially the same as in an assignment of the lease — financial condition, previous business experience, guarantor and administrative fee.

Status of Lease

When requested by a tenant to agree to an assignment or sublease of a space, the analysis for a landlord varies somewhat based on whether a tenant is near the end of the lease term (and the landlord wants the tenant to extend the lease) or has any rights to terminate the lease. If a tenant is still in the middle of a lease term without a right to terminate, then the tenant's leverage is lower and any requests by the tenant for reductions in size of office space through assignment or subleasing will depend in large part on the terms of the existing lease.

A tenant's leverage in negotiations when requesting a reduction in office space size is higher if the lease provides the right for a tenant to terminate. Therefore, landlords need to fully understand the provisions of the existing lease before engaging in a discussion with the tenant.

Surrendering Part of the Lease

While assigning or subleasing all or part of the space means that there will be a new tenant to accept the assignment or sublease, a landlord may want to agree to allowing the tenant to surrender part of the space even if a new tenant for the surrendered space is not available.

The terms of a surrender of the lease are subject to negotiation, as it is unlikely covered in a lease, so the landlord can use this opportunity to request certain changes to the lease that are in the landlord's favor, such as an increased amount of rent per square foot paid by the existing tenant for the reduced space or a longer term for the lease. Additionally, a landlord may consider assessing the existing tenant with a surrender premium to compensate the landlord for all or part of the lost rent and any fees and costs associated with negotiating the surrender. The financial condition of the tenant should be analyzed when making this determination, including disclosure of any loan proceeds.

In the end, a landlord may allow the tenant to surrender part of the space in order to enable the tenant to be able to afford to remain in the reduced space, which avoids an abandonment of the lease by the tenant.

Rent Considerations

There have been many discussions that tenants may not require as much office space in the future because employees are now accustomed to working from home. These discussions may be premature, as ultimate resolution will not occur until after the COVID-19 threat has passed and tenants are able to return to work without limitations.

As tenants begin to assess whether they require reductions in office space, landlords may want to give tenants time to consider if those reductions will be necessary in the long term by temporarily reducing the tenant's rent. This will allow the tenant the ability to assess how much office space is needed and allow the landlord to avoid vacancies. A tenant may find, once the employees are allowed to come back to the office for work, that they desire to do so and/or that as much or a greater amount of the office space is needed to allow for social distancing, even with less employees.

Loan Considerations

When analyzing any requests from a tenant regarding decreased rent or reductions in office space, a landlord will want to ensure that the options either do not violate any obligations under any existing loans on the property and that the landlord has obtained the consent from the lender, if required. The loan documents may require a certain rent roll on the property or debt service coverage ratio, which could be affected by the rent reductions or surrenders.

Further, the loan documents may require lender approval for any modifications to a lease, including terminations. Therefore, a landlord will want to thoroughly analyze whether any provisions in the loan documents are affected by the lease considerations addressed above. If so, a landlord will want to begin discussions with the lender regarding the proposed changes and obtain written consent from its lender before agreeing to any lease modifications.

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