Law & Accounting

Be prepared to handle tenant requests for less space

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Employers have reopened office spaces around Colorado after the expiration of stay-at-home orders related to COVID-19, and many have an idea about the new normal for their operations.

In some cases, this will involve fewer people in the office with work-from-home arrangements proving beneficial or because downsizing has become inevitable. Business leaders might be considering part-time hours or "hoteling" for employees and other options that could result in a reduction of overhead through reduced commercial real estate space. Alternatively, office spaces might need to be physically altered to allow for social distancing, and landlords may be requested to modify existing leases prior to their full term.

This will require balancing the changing needs of tenants with the economic realities related to COVID-19 and the potential altered landscape moving forward. The options below provide creative options to assess in order to keep tenants in place or to reduce the negative financial consequences when changes are made.

■ **Assign office space to a new tenant for existing term.** An assignment of the entire lease provides for a direct relationship between the landlord and the new tenant. A landlord also can 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 since landlords do not typically want to have additional tenant responsibilities.

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 pay rent obligations on time.

Much like an assignment of the lease, a landlord can agree to sublease all or part of the space to a new tenant, and 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, including the collection of rent from the subtenant.

The items that a landlord will want to consider in consenting to an assignment or granting a sublease vary depending upon the terms of the lease or the items requested by the landlord. However, a review of the financial condition and previous business experience of the new tenant to evaluate the likelihood of the new tenant abiding by the terms of lease will be one of the most important.

■ **Surrender part of the office space.** A landlord could consider allowing the tenant to surrender part of the space even if a new tenant is not immediately available. The financial condition of the tenant should be analyzed when making this determination, including disclosure of any loan proceeds.

The terms of a surrender of the lease are subject to negotiation, as it unlikely is 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 tenant for the reduced space or a longer term for the lease. Additionally, a landlord may consider assessing the 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.

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 vacancies.

■ **Rent considerations.** Discussions related to the viability of permanent work-from-home arrangements may be premature as an 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, 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 fewer 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 do not violate any of its 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 rent reductions or surrenders.

The loan documents also may require lender approval for any modifications to a lease, including terminations. 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.

■ **Conclusion.** The possibility exists that the landscape of office space needs will be permanently altered post-COVID-19. Tenants are just as likely to require different configurations, as they are to require reduction in office space. An understanding of whether these changes are temporary or permanent is critical to assessing options.

Landlords should be prepared to field requests and use all available tools and analysis to find the best solutions. ▲