

Challenges & Opportunities

In Office Leasing In 2010

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Office leasing continues to be a challenge this year as the economic downturn forces base rental rates to decrease and the value of concession packages available to tenants to increase. During the first quarter of 2010, base rents in Chicago's central business district dropped by at least 5% to an average of \$18.90 per square foot. The economic packages being offered to tenants

generally include 9 to 12 months of free rent and an average allowance of \$55 to \$75 per square foot. Cash-strapped landlords, however, will offer larger rent abatements instead of an allowance.

Leasing activity during the first quarter of 2010 was primarily related to renewals, which may present opportunities for tenants. For example, a tenant can use the lease renewal process to obtain various concessions. Most likely, the tenant can negotiate a lower base rent or give back some space as part of the renewal process. Even if the lease terms do not provide for any concessions in consideration of the renewal, the landlord may, if asked, agree to sweeten the deal in order to preserve the tenancy. No matter the circumstances, it is prudent for tenants to engage the services of a real estate broker who understands the market and the opportunities it offers.

In light of the difficult economic environment, it is no surprise that landlords are being asked to renegotiate leases that are in default. Landlords should start by reviewing relevant financial information to verify a downturn in the tenant's business. If the parties are able to work out a deal, the landlord should require a personal guaranty for the repayment of the rent arrearage and for prospective rent payments under the amended lease. The landlord may also want to require a larger security deposit and demand that the tenant forfeit certain rights contained in the existing lease, including renewal and termination options, as well as exclusivity provisions. The landlord can also require that the new economic terms be subject to a confidentiality agreement between the parties.

In many instances, tenants whose leases are not up for renewal are instead seeking to sublease space. Presently in Chicago's central business district, there is about 2.7 million sq. ft. of office space for sublease in direct competition with landlord-controlled space. A tenant seeking to sublet space should review its lease for related restrictions. In some cases, the landlord has the right to recapture the proposed sublease space or withhold its consent in its sole discretion. The lease may also prohibit a sublease to another building tenant.

Many landlords today are in default on their mortgages. However, a tenant involved in lease negotiations may be unaware of this financial distress. Tenants should protect their interests by requiring a subordination, nondisturbance and attornment agreement from the landlord's mortgagee. This type of agreement will prevent the lease from being foreclosed by the mortgagee so long as the tenant is not in default under its lease. The tenant should also request that the mortgagee acknowledge in the agreement that it will be bound by any allowances or rent concessions that the landlord agreed to provide to the tenant in the lease, as well as any construction obligations of the landlord. This is especially important for tenants relocating to new space or expanding their space. A tenant should ask the landlord to escrow the tenant allowance and have the mortgagee agree that the monies will be available for the build-out even if the landlord goes into default under the mortgage. Remember that the mortgagee, as successor to the landlord, may not be obligated to honor any agreements made between the landlord and the tenant in a lease or lease amendment unless the mortgagee agrees to be bound by the same in writing. There are currently no new commercial buildings under construction in Chicago's central business district. As a result, existing owners have an opportunity over the next few years to capture new leases and lock up lease extensions without competition from new buildings.

Clearly, leases being negotiated in 2010 are being affected by current economic conditions, and both landlords and tenants continue to face new and challenging issues. However, leases can be completed if each party does its due diligence, is willing to be creative and communicates with the other side (and the mortgagee) in a frank and honest manner.