

## Tips to Maximize

# Office Leasing



**W**hile office leasing has generally been on the rise throughout 2011, the commercial real estate market appears to have sustained lasting change brought about by the recession. Landlords and tenants continue to amend existing leases at lower base rental rates. At the same time, landlords are offering larger concession packages to entice new tenants and keep existing tenants in their buildings.

As parties negotiate new leases, lease renewals and lease amendments in this challenging environment, landlords and tenants should take into account a number of key factors. There are many tips on how landlords and tenants can maximize their position.

✓ **Use relocation to leverage lower rents**

Overall, it is actually a good time to be a tenant in the marketplace. Net rents have decreased nationwide, although the rate of decline has begun to slow in stronger areas of the United States. In the Chicago central business district, for example, base rental rates are currently equivalent to 2007 rates.

- Tenants whose leases expire within the next two to three years can use relocation as leverage to negotiate an extension at lower rents. One way to accomplish this is to work with a broker to procure

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letters of intent to lease space in other buildings. This process not only can provide a barometer of rental rates in the market, but also will assist the tenant in negotiations with the present landlord.

### ✓ **Rightsize the premises**

Rent may be a company's largest fixed obligation and generally escalates over the lease term. Many tenants, having reduced their staff to cut overhead costs, find themselves paying rent on excess space. Therefore, a space reduction that leads to lower rent may be helpful to struggling tenants.

- In situations where the lease is scheduled to expire or may be subject to a termination option, it is appropriate to negotiate downsizing the leased premises and requiring the landlord to demise a smaller space. Many landlords are willing to accommodate the tenant's desire to reduce its premises in order to keep the balance of the original premises leased under new terms. After all, the landlord wants to continue to receive cash flow and avoid a prolonged vacancy.
- Subletting space to a third party—now a huge component of every office marketplace—is another viable way for tenants to downsize and address the economic burden of carrying vacant space.

### ✓ **Negotiate incentives in new leases**

Every new lease offers the tenant an opportunity to negotiate a variety of incentives or concessions.

- Qualified real estate brokers who understand the nature of the economic incentives in a particular marketplace are a tenant's best advocate during the negotiation process. A tenant should also be represented by a qualified attorney who understands the nuances of an office lease. It is safe to assume that the initial draft of a lease will be landlord friendly, but an experienced real estate lawyer can make the terms more balanced on behalf of the tenant.
- Rent abatement is a common incentive but is usually spread over the term of the lease. For example, if the tenant receives six months of free rent, the landlord may minimize the impact to cash flow by making the free rent





available at the rate of two months in each of the first three years of the lease.

- Build-out allowances have increased over the last few years, ranging from US\$5 to US\$150 per square foot, as another way to attract new tenants. It is in the best interest of both the landlord and the tenant that the lease clearly articulate how this allowance can be used, the mechanism for obtaining the money and whether any excess funds not used in the build-out will be forfeited or can be applied toward rent.

It is a good idea that the allowance be escrowed if the tenant wants to be certain that the landlord has the means to pay it all. If the tenant's budget exceeds the allowance however, the landlord may insist that the tenant place the overage in escrow for the same reason.

- Additionally, tenants can be proactive and negotiate contraction and termination rights into a lease. Although there is generally a cost associated with exercising these rights, it may make sense if the demised premises are no longer serving the tenant's needs.

Typically, the landlord will require a fee based on the lost rent and reimbursement for the unamortized transaction costs associated with the space being relinquished. Transaction costs—usually amortized over the term of the lease—include brokerage commissions, rent abatements and build-out allowances that were initially incurred by the landlord under the lease. The lost rent may be calculated on a present-value basis.

#### ✓ Cooperate with due diligence efforts

If a tenant requests that the landlord renegotiate its lease, the landlord has no legal obligation to do so. However, to be practical, the landlord may at least take steps to confirm that the tenant's business has been adversely affected by the economic times and that assistance through a lease amendment is warranted.

- The tenant should be prepared to provide tax returns and financial statements covering at least two to three years. The landlord may also request projections in order to better understand the tenant's future economic outlook. With this information, the

landlord can make a reasoned evaluation of the tenant's need for concessions through a lease amendment.

- In this scenario, the landlord may require a larger security deposit or personal guaranty, or seek to eliminate certain lease provisions. For example, the tenant may be required to eliminate its right to expand, its right of first refusal, or its right to terminate the lease. In some situations, a landlord might require a tenant to waive an exclusivity provision—which is often viewed as an impediment to leasing space in the first place.

#### ✓ Consider subleasing space

As mentioned earlier, subleasing space can be a viable way to rightsize the premises and reduce expenses. However, there are a number of potential pitfalls.

- Tenants should begin by reviewing their leases to ascertain whether or not there are restrictions on subletting the space. In most cases, the landlord has the right to approve a sublease in its sole discretion and may apply certain restrictions. For example, the landlord will want to make sure that the subtenant does not change

the use of the premises and will also want to know whether the tenant is making a profit on a sublease, as the landlord may be entitled to share in that profit.

Furthermore, office leases often allow the landlord to recapture the proposed subleased space and terminate the tenant's lease with respect to that space. This enables the landlord to enter into a direct lease with a third party, which is especially appealing if the space was being leased below the market rate.

- Oftentimes, sublease provisions restrict negotiations with other tenants in the building or any prospective tenants with whom the landlord has already had dealings. There may be restrictions against subleases with certain types of subtenants too (i.e. government agencies). The landlord is in the business of leasing space and should not have to compete with a tenant seeking to sublet space at rates below what the landlord is asking for vacant space in the same building.

### ✓ Beware of distressed ownership

In today's economic environment, many owners of office buildings are actually in default under their mortgage debt. However, neither the real estate broker nor the tenant may be aware of this fact. As a precaution, the tenant should always require that the mortgagee approve a new lease or a lease amendment.

- Many building owners escrow tenant improvement dollars and brokerage commissions with the mortgagee on a monthly basis because leases expire from time to time and the mortgagee wants to be certain that monies will be available to replace the tenants if necessary. If the build-out dollars are coming from the mortgagee, the tenant should satisfy itself that the funds will be available. The mortgagee should agree in writing to fund an escrow with a title company.
- It is advisable to require the landlord to procure from the mortgagee a subordination, nondisturbance and attornment agreement (SNDA). An SNDA assures the tenant that the mortgagee will not disturb the tenant's right to so-called "quiet enjoyment" of the premises—

whether or not the building goes into foreclosure—so long as the lease is not in default.

If there are future economic obligations of the landlord to the tenant, it is prudent to request that the mortgagee agrees to assume the landlord's obligations in the event the mortgagee succeeds to the interests of the defaulted owner. Landlords typically resist making the SNDA a condition to the lease and may or may not be willing to seek out the mortgagee in this regard. However, given the precarious nature of commercial real estate these days, it is important to pursue an SNDA from the mortgagee.

### Securing a fair deal

In summary, landlords and tenants today face risks and opportunities in office lease transactions. Therefore, it is important to understand the marketplace and to be well-represented by a broker and an attorney in order to secure a fair economic deal, as well

as a reasonable lease document that both parties can live with for a fairly long time. **FMJ**



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