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Leasing:
Five Ways Landlords Can Protect Their Investment in a Soft Office Leasing Market

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It is no secret that the work from home trend, space optimization efforts and suburban office competition have caused, and are continuing to cause, rising vacancies in downtown and central business district office markets. To protect their investments, landlords of office buildings must rethink their leasing strategies to maintain occupancy rates and stabilize rental income. Tenants have more negotiating leverage in the current market, which makes it critical for landlords to proactively structure lease terms that attract new tenants and retain existing ones. Here are five key strategies landlords can implement to navigate office leasing in today's tough economic environment:

1. Offer Flexible Lease Terms with Strategic Concessions

Tenants are seeking shorter lease terms, early termination rights, rights to contract their leased premises, rent reductions, and other similar incentives. Landlords should be prepared to offer flexibility without compromising long-term value. Consider strategies such as:

- **Rent Abatements**: Providing temporary rent relief in exchange for a longer lease term. Temporary rent relief can occur at specified intervals throughout the lease term, rather than only for a period at the beginning of the term.

- **Gradual Rental Structures**: Offer lower initial rents that gradually increase over time, enabling the landlord to recoup initial reductions on the back end of the term.

- **Shorter Lease Terms with Short Renewal Options**: Allowing tenants to commit to shorter leases while securing shorter options for renewal at predetermined terms.

- **Early Termination Options**: Allowing tenants to terminate the lease prior to the scheduled expiration date may give tenants comfort in committing to a longer overall term.

2. Enhance Tenant Improvement Allowances (TIA) with Safeguards

Tenant improvement allowances are a powerful tool to attract new tenants and to retain existing tenants who desire to upgrade their existing space. The TIA should be structured carefully to protect the landlord's investment. Consider the following approaches:

- **Performance-Based Disbursement**: Releasing funds only as specific improvement milestones are met, or releasing funds only after all improvements have been made, the tenant has provided paid receipts and lien waivers for the work, and the landlord's architect has certified that the work has been completed in accordance with the previously approved plans or drawings.

- **Amortization of TIA Costs**: Recouping the improvement costs through higher rent over the lease term, and including lease provisions that require the tenant to reimburse any unamortized portion of the TIA Costs if the tenant defaults.

- **Reversion Clauses**: Ensuring that improvements become the landlord's property at the end of the term such that the tenant improves the landlord's building.

- **Creative Uses**: Allowing more flexibility in the use of TIA (e.g., for furniture, fixtures and equipment, or to offset the tenant's share of pass-through expense , but lender approval should be a consideration.

By carefully crafting TIAs, landlords can support tenant success while maintaining control over capital expenditures.

3. Negotiate Stronger Security Deposits and Personal or Corporate Guarantees

In uncertain economic conditions, mitigating tenant default risk is crucial. Landlords can strengthen lease security provisions by:

- Conducting a thorough review of Tenant's creditworthiness (request the most recent financial statements) and requiring ongoing financial reporting.

- Requiring larger security deposits, especially for tenants with uncertain financial standing. To make a larger security deposit more acceptable for a tenant, consider including "burn down" provisions that gradually reduce the amount of the security deposit to a lesser amount as the tenant demonstrates its commitment to perform the lease obligations.

- Obtaining personal or corporate guarantees to secure Tenant's obligations. Often, the tenant entity is a special purpose entity with limited assets. A personal guarantee from one or more principals of the tenant entity or from a parent or affiliated entity provides the landlord with assurances that the obligations of the tenant will be fulfilled.

These protections ensure landlords have financial recourse if a tenant struggles to meet its lease obligations.

4. Implement Innovative Rent Structures

- For start-up companies leasing office space, landlords may consider using a rent structure typically seen only in retail leases: percentage rent. The landlord may charge a lower-than-market base rent plus a certain percentage of gross revenue over an agreed upon threshold. If the start-up succeeds, the landlord shares in the upside but if the start-up struggles, the rent remains manageable.

- Another strategy for start-up companies leasing office space involves landlords negotiating an equity position in the start-up lieu of rent, or some combination of both rent and an equity position.

- A landlord may consider deferring rent for an initial period in exchange for higher-than-market rent later in the term.

- For seasonal businesses, landlords could help tenants manage cash flow by charging lower rents during off-season period with higher rents during in-season periods.

These approaches make leases more attractive to tenants while allowing landlords to share in potential upside gains.

5. Prioritize Tenant Retention and Lease Extensions

Keeping existing tenants is typically more cost effective than attracting new ones. Landlords can encourage renewals by:

- Offering Renewal Incentives: Providing rent discounts, improvement allowances, flexible terms, rights of first refusal, or new amenities.

- Regular Communication and Relationship Building: Maintaining open dialogue with tenants to anticipate needs and address concerns proactively.

- Early Lease Renewal Negotiations: Initiating discussions well before lease expiration to secure long-term commitments.

By fostering strong tenant relationships and providing renewal incentives, landlords can maintain occupancy and reduce the risks associated with vacancies.

A down market presents challenges, but with proactive lease strategies, landlords can protect their investments while maintaining tenant occupancy. By offering flexible lease terms, structuring TIAs with safeguards, strengthening security provisions, considering revenue-based rent models, and prioritizing tenant retention, landlords can navigate market downturns while positioning themselves for long-term success. Thoughtful and strategic lease negotiations will not only attract tenants but also help stabilize rental income and preserve property values.

Further Protections

If you have leasing questions, please contact Marcy Hamilton at meh@muslaw.com, or any other Meyer, Unkovic & Scott attorney with whom you have worked.

Marcy specializes in advising companies and individuals on all aspects of commercial real estate transactions with an emphasis on office, retail, and industrial leasing. Marcy has been included in every edition of "Best Lawyers in America," the definitive guide to legal excellence, since 2020.