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Office Tenants are Poised to Take Advantage of Vacancies

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Due to the well-publicized turmoil in the financial sector, including bankruptcies, consolidations, mergers and retrenchments, it is expected that millions of square feet of vacant office space will be added to western metropolitan markets this year. This has created a unique opportunity for office tenants, as we go from the relatively tight rental markets experienced in 2007 and 2008 to a market where a tenant can expect to have substantially more negotiating leverage. For companies that are renewing or expanding space this year, it is a good time to make a deal. Here are some key issues that a tenant should consider in negotiating a new office lease:

Rental Rates. Obviously, the rental rate is the foremost business issue of concern to most tenants. Office rental rates, which were relatively stagnant in 2007 and most of 2008, have begun to drop precipitously in most metropolitan markets. For San Francisco, Studley, a brokerage firm that exclusively represents tenants, determined that rents for Class A office buildings dropped 13.9% in the fourth quarter of last year, and estimates that rents may have dropped another 10% to 20% since then. Studley also estimates that the Class A availability rate (direct space and sublease space) increased to 15.2% by the end of last year.

To get the best rate possible, a tenant should hire an experienced real estate broker with particular knowledge of the relevant market area. Even under stable market conditions, it would be difficult for a tenant to determine on its own a fair rental rate, considering all of the factors going into this calculation, including free rent, tenant improvement allowances, moving allowances, useable square feet as compared to rentable square feet, building efficiencies with regard to operating expenses, views, etc. It is particularly difficult to make this determination under the current volatile conditions. Relying on the services of an experienced real estate broker is critical to insuring that a tenant does not overpay for space.

Sublease Space. Much of the new space that will be placed on the market in the next six months will be sublease space from businesses that have been acquired, are consolidating or are downsizing. There are a number of advantages and some pitfalls to consider when subleasing office space. On the positive side, sublease space typically rents at a discount to space under a direct lease. Also, much of the space will be so-called "plug-and-play" space that can be ready to occupy in a short period of time and may include furniture and office equipment. The wide availability of plug-and-play space may give a tenant more flexibility in determining when to make a decision to sign a new lease. Instead of having to plan for a move a year or more in advance, a tenant could have an additional six to nine months to pull the trigger on new space. This flexibility could allow a tenant to wait out a market that is only in the early stages of responding to the current economic malaise.

Sublease space, however, presents some unique legal issues that a subtenant will need to consider. The most significant issue is that a sublease is subordinate to a master (or prime) lease and therefore could be extinguished in the event that there is a default under the master lease. This is of a particular concern where the subtenant is leasing from a sublandlord of questionable financial condition, which is often the case. In order for a subtenant to protect itself in this circumstance, it should seek to obtain a recognition or non-disturbance agreement from the master landlord providing that the subtenant may continue in the sublease space under the terms of its sublease (or other terms) even if the master lease is terminated due to a default by the sublandlord. Traditionally, office landlords have been reluctant to provide such an agreement. In a bad market, however, a landlord may be more willing to give a non-disturbance agreement in order to get a good tenant into the building and a good prospect for renewal.

As a fallback, a subtenant may be able to obtain an agreement from the master landlord that it will notify the subtenant in the event of a default under the master lease and provide it with an opportunity to cure the default. The subtenant will want to negotiate in the sublease the right to offset from sublease rent any amounts paid by subtenant to cure the master lease.

More Frills. The tenant should think about additional goodies to ask for in its office lease. These could include free rent, parking rights, storage space, options to extend at fixed or lower than fair market value rent, options to expand, early termination rights, special signage privileges, greater tenant improvement allowances, moving allowances and other tenant concessions.

Operating Expenses. Most office leases provide that operating expenses will be passed through to the tenant (either fully, as in a net lease, or to the extent exceeding operating expenses incurred in the base year, as is the case with a full service or gross lease). The tenant should negotiate exclusions to operating expenses including capital expenditures, and increases in taxes based on reassessments (so-called Proposition 13 protection). For full service (base year) leases, the tenant will want to make sure that the property is fully assessed for tax purposes in the base year. If the property has an artificially low tax assessment in the base year due to temporary reductions (as allowed in California under Proposition 8), the tenant should insist that this amount to be grossed up when compared to taxes of subsequent years.

Protection From Foreclosure. In many metropolitan markets, office buildings purchased from 2006 to 2008 have lost a substantial percentage of their value. This will make it difficult for many building owners to refinance these properties when their loans become due in the next few years. Furthermore, the drop in rental rates has made it harder for some owners to make their mortgage payments. This presents a serious risk of foreclosure which could result in the termination of any lease that is subordinate to the foreclosed loan. Therefore, similar to the sublease situation described above, it is important for a tenant to obtain a non-disturbance agreement from a landlord's lender at the time the tenant enters into a lease to protect its lease.

Letter of Intent. While the market is heading in the tenant's favor, the tenant should be careful not to sign any letter of intent unless it is clearly non-binding. The tenant will want to keep its options open until the point of signing a new lease. You never know when the next deal might come along that is better than the one you are looking at. Many of us recall the days before the dot.com bust when many landlords would not hesitate to pull out of deals for a better offer, even though there was a signed letter of intent in place.

Current market conditions are extremely favorable to tenants in need of office space. Even a tenant with a lease that is not set to expire for two or three years should consider approaching its landlord about extending the lease at a lower rate that could be phased in during the remainder of the current lease term. When negotiating an office lease, a tenant should consider the key issues described above. Furthermore, in order to take full advantage of the current market and to protect itself from risk, a tenant should consult with an experienced real estate broker and have its lease reviewed by a competent real estate attorney.

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