Dealing With Excess Office Space In A Post-Pandemic World

By **Simon Adams** (March 8, 2021)

Simon Adams

It will come as no surprise to you that business are now emerging from the fog of the COVID-19 pandemic to a new reality that will require adjustment to their use of space.

As facilities and work space departments review the landscape, it will be apparent to the executive boards of many organizations that employees do not all need to be occupying expensive real estate to perform many tasks that were carried out from their home work spaces with accuracy and while meeting milestones on time for the betterment of the organizations goals.

The San Francisco Bay Area, the hub of innovation in the U.S., has already begun to establish the rules. Do not be fooled into thinking that the headlines of technology companies allowing long-term work from home positions will be only for these cutting-edge firms that have millennial engineers able to code in a coffee shop by day or willing to burn the midnight oil on a skinny tablet from a city center micro apartment at night.

I strongly believe the real estate rules have changed forever and will encompass every organization in some form or other.

Even if you are a manufacturer of auto parts with necessary plant and equipment humming away in large warehouse space, your team will still be looking hard at the back-office support functions of accounts receiving and delivery, human resources and other office space functions to answer the questions, "Can we be more efficient? Will having less space benefit the bottom line, month in and month out?"

For many businesses with medium or large workforces, the first step will be to identify facilities where an adjustment can be made. It will likely focus on leased space, though even owned space may be under consideration if the opportunity to sublease areas long-term and generate revenue is factored in.

Once an inventory is taken, the company will survey employees to confirm what management may have begun to understand after running an organization successfully for a year with few employees commuting to an office. These surveys will be intended to identify future desire to return to an office full-time, or to some alternative such as shared space arrangements or hot desking.

Once the results are in, then the planning will begin with internal teams addressing various issues. Certain companies will need to seek guidance from their accounts departments. Various publicly traded organizations that make restructuring plans may find themselves looking at restrictions or limitations of how they can best deal with excess space.

Some companies have reported on a desire to surrender up space immediately to their landlord, who has little interest in recapturing the space, which has resulted in the excess space being mothballed.

Restructuring plans dictated by accounting rules have resulted in vacant space being closed and not placed on the market for sublease, and monthly payments being made in a timely manner to the landlord. Provided that any reasonable security or insurance issues are addressed to meet any landlord concern, even a covenant to occupy will be difficult to enforce without substantial cost to the landlord.

Why may we see this happen? Landlord asset managers often believe their lenders will require that an early termination payment from a tenant be paid to loan principal, making the acceptance of accelerated receipt of rent less attractive than retaining the building lease profile.

Similarly, some tenant organizations may be unwilling to make a large single payment to terminate a long-term lease obligation. Where there is a market for subleasing space, then there is an ability to supplement the rental outlay on the excess space if the tenant is not challenged by some unusual accounting direction.

But what if the markets have moved to a new reality with low absorption of space available for lease because every business is looking at these issues? Then factoring periods of extended vacancy might make the buyout of a lease seem more attractive.

Do not forget that it is not only a base rental obligation that continues. The typical office lease will require a tenant in a triple net arrangement to pay for its share of the building utility costs, insurance cost and real estate taxes in addition to paying for the tenant's insurance and any supplemental expenses such as parking or signage rights. When calculating the long-term hold cost of a lease, do not overlook the additional rent and do not forget to account for inflation.

If you are responsible for the building assets and represent the landlord that would have a preference to retain the lease of a vacant space rather than work through the efforts of a buyout, consider the risk of a tenant business failure.

As a good rule of thumb, if you have five or more years to run on a California lease and your tenant files for bankruptcy protection to reorganize, then the landlord will not only find the court requiring the tenant to make an election to either affirm or reject the lease, which we can assume will be swiftly rejected when it comes to excess space, but recovery is going to be limited to approximately a year of rent.

The exact formula of the amount the landlord will recover is more complex, but this guidance should be in mind when thinking about allowing a prebankruptcy buyout of the lease. Provided that the lease termination fee is paid and the transaction is performed in a reasonable period prior to the bankruptcy filing, the termination fee is unlikely to be deemed to be a preference and recoverable by the trustee.

Other issues for asset managers to watch for in this new environment will include a review of the security held against lease obligations of tenants in each building.

Some publicly traded tenants may have negotiated for a lease without any additional security deposit or other form of guaranty or protection afforded by the landlord.

If that tenant vacates, then it may be time to consider whether the lease has terms that will permit the landlord to seek some security in the form of a letter of credit to hold against the risk of a tenant seeking reorganization.

If you are a landlord holding letters of credit, understanding how these are drawn and what steps are required of the issuing bank may become of importance. It is not common to see draws on such security instruments, and not every asset manager will know the procedure without taking advice.

What should be your goal? For a tenant of excess space, the target should be to release the organization of long-term risk both for the monetary outlay in the rents but also the liability of being responsible for real estate. Note that even tenants of empty space are going to retain the liability of a bodily injury claim if a landlord contractor has to enter the space to perform some work in your space and suffers some unforeseen accident.

Landlords must consider whether the termination payment can be made in such a way as to permit the landlord to carry the cost of the space until a suitable qualified tenant can be signed to a new lease.

This carry cost provided by the lease termination payment might need to address some necessary expense of amortized broker's fees and tenant improvement allowances. If the prior use is unusual, then consider the cost of demolition as part of the price that landlord will pay in order to find that next tenant.

Simon Adams is a partner at Nossaman LLP.