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Practice Update

Considerations for Office Landlords and Tenants in a Post-Pandemic Climate

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By William J. Bernfeld

It's not news that the office buildings in most big cities have been under stress as a result of the pandemic. Due to increases in remote work, when leases roll, many tenants are either not renewing or they are taking less space. According to CoStar data, "average U.S. office values have fallen to about 4% below pre-pandemic levels, the worst performance of any type of commercial real estate." Lower valuations complicate the struggle to obtain new financing in a lending environment that is growing tighter against the backdrop of rising interest rates and regional bank failures.

Some landlords have simply handed over the keys to their lenders, which is a change in behavior since the Great Recession. Many others remain in business, but their financials are not stellar. Only a limited number of big city markets (such as Miami) have yet to experience this phenomena.

Generally speaking, it's a tenant market in the office sector. Landlords are offering higher broker commissions to attract tenants, and tenants want newer buildings, more free rent (in addition to lower rent), significant amenities, as well as early termination rights.

As part of their due diligence, tenants now inquire what percent of the building is leased, and whether

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the debt on the building is current. In California, tenants are asking landlords to apply for a Proposition 8 “downward assessment,” where the current property value has dropped lower than the assessed value, which will reduce property taxes that are passed through to tenant.

For new leases with a tenant improvement allowance, particularly when it’s the tenant who retains the contractor, tenants likely ask for some form of security from the landlord, such as an escrow for the tenant improvement allowance funds, or a guaranty from a landlord affiliate with a healthy financial statement, and/or offset and abatement rights tied to the cost of borrowing (which might include a premium) in order to protect the tenant, should the landlord fail to disburse tenant improvement money. In addition, tenants are asking for subordination and nondisturbance agreements which obligate the lender to fund the disbursement of tenant improvement allowances post-foreclosure.

With incentives factored in, landlords are collecting less rent than five years ago. With back to office mandates, including President Biden’s recent request that federal agencies increase the number of employees who report for in-person work this fall, it remains to be seen how the office market will respond.
