

The great office space reset: problems and solutions for tenants and landlords

By David Wald, Wald Realty Advisors, and David Kupetz, Esq., Locke Lord LLP

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The seismic disruption of ‘work from home’ has transformed the conventional thinking about how we use office space and turned it upside down. As those powerful forces ripple through the workplace, both landlords and tenants are trying to find successful ways to productively address the way office space is used.

Issues

It’s no secret that if a company used a significant amount of office space prior to the pandemic, it’s likely they now have more space than they need. Or, at the very least, they don’t need as much space on certain days of the week, or they may need to divide it up into buildings in different locations.

Until recently, office space was both a functional necessity and a powerful marketing tool. Office space was an important way to convey how capable and successful a business was.

Today, thanks to the internet and the shift to remote work-from-home, office space is now primarily about function: The productive and efficient operation of a business.

The question today for many tenants is how will they use their office space going forward — on what days will they use the space and how much office space do they need? How do they recalibrate their existing office space lease commitments without waiting years for existing lease(s) to expire?

With typical office lease terms of five to ten years or more, and leases that can’t easily be modified or terminated, there are usually no easy, unilateral options available to tenants to restructure or give back existing office space. The best outcomes typically arise from collaborative efforts between landlords and tenants. But as that won’t always be the case, it’s better to hope for the best, but plan for the worst.

What follows is a brief exploration of considerations and various strategies that tenants and landlords may use to rebalance their existing office space, including some different ways of thinking about how to use surplus office space.

The good news is that everyone who uses or leases office space is working through these issues. These are unique and difficult times for both tenants and landlords. As a result, both will be working through the process of finding creative and productive solutions to recalibrate office space use in the months and years ahead.

Considerations

Every company is different, as are its business structure and leases. Given the wide variation of circumstances, there is no ‘one size fits all’ approach. At one end of the spectrum, some businesses will maintain office space in the same manner that they did prior to the pandemic. At the opposite end, some companies will go entirely remote. Most will likely fall somewhere in between.

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Tenants are now in the process of determining what type of office space they need, how much, on what days of the week, and where the space should be located. Some tenants may even conclude that they can go completely ‘virtual’ with the use of shared or co-located office space and new services like third-party mail collection.

It is also important for both landlords and tenants to carefully review the provisions of existing lease(s) and consult with an attorney who has experience both with business operations and office leases. It’s important to fully understand the potential costs and risks before acting on any plan. Most importantly, make sure there’s a plan in place before taking any action.

Practical strategies

Here are some of the practical strategies that tenants will consider in their efforts to right-size their office space, ranging from simple and relatively low risk to more complex and high risk.

Share the space

Tenants may find that excess office space can be transformed into a powerful marketing tool, particularly professional service businesses like law, accounting, architecture, engineering or consulting firms. Sharing space or co-locating with key clients or collaborators can be a good way for a tenant to leverage underutilized space.

As a tenant’s clients downsize their own offices — or in some cases even go fully virtual — they will typically still need small, well-appointed event spaces, conference rooms, private offices and



workspaces. Offering those clients the opportunity to co-locate – whether it’s done as a courtesy or for a fee — can strengthen client relationships, enhance client collaboration and open the door to new business opportunities.

Make sure to check the lease for subletting restrictions and income sharing provisions.

Talk to the landlord

It (usually) doesn’t cost anything to talk. Tenants may find that simply telling the landlord that it has excess office space and would like to find a collaborative solution to reduce the space before the lease expires may be all that’s necessary to accomplish the tenant’s goals.

The landlord may have other tenants that want some or all of the space, or would be amenable to take back some of the space, relocate the tenant, or significantly reduce the rent in the interest of retaining the tenant and its good will. If the tenant is one of the few remaining tenants in the building, the landlord may also be receptive to terminating the lease to facilitate the landlord’s plans to convert the building to another use.

Sublease the space

A tenant can sublet its excess office space. If it’s just a few surplus offices, putting the word out to peers in compatible businesses may be all that’s necessary to sublet the excess space.

On the other hand, if significant portion of a tenant’s existing office space is surplus, then it’s often better to list the excess office space with a broker that specializes in subleasing similar office space in the area. However, in a soft market, there will typically be many other companies also seeking to sublet their surplus space.

Move out

Although a far riskier and potentially more costly strategy, a tenant may elect to vacate its surplus space and hand back the keys to the landlord. In some cases this can set in motion the conditions for a favorable negotiated outcome, depending on the specific terms of the lease(s) and applicable state law.

Particularly in circumstances where the landlord is in distress and unwilling or unable to provide the building services committed under the lease like security, heating and air conditioning and janitorial, the landlord may be willing to terminate the lease rather than litigate.

Tenant breach

When a tenant is in breach of a lease, the landlord’s remedies are governed by the lease and applicable state law. Assuming that the parties are unable to reach a consensual lease modification or termination agreement, the landlord may seek to evict the tenant and to recover damages. Generally, leases and state law dictate the required notice of and cure period for monetary defaults.

If there is a guarantor of the tenant’s obligations under the lease, the landlord may pursue recovery from the guarantor in addition to seeking relief against the tenant. The lease and/or state law

may require the landlord to mitigate its damages, but in a seriously declining rental market, any benefit to a tenant from such a requirement may be illusory.

Landlord defaults

Depending on the terms of the lease and governing state law, a tenant may also have various remedies available when a landlord fails to perform its obligations under the lease, potentially including:

- (1) perform at its own expenses and deduct the cost from the amount of rent due;
- (2) surrender possession of the premises, cease paying rent, and seek recovery of damages;
- (3) deduct from rent the difference between the rental value of the premises as it would have been if the lease had been fully complied with by the landlord and rental value based on the actual condition of the premises; or
- (4) continue with the lease, keep paying rent, and sue for damages. The failure of the landlord under a commercial lease to maintain the premises, may constitute a breach of the covenant of quiet enjoyment that would justify the tenant’s abandonment of the premises for a constructive eviction, but governing law may dictate that a tenant who remains in possession is liable for rent that accrues during possession.

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Moving out also typically triggers the landlord’s obligation to affirmatively begin marketing the space for lease.

Pre-planned bankruptcy

Depending on how a tenant’s business is organized and how urgent it is to downsize the offices, a pre-planned bankruptcy restructuring may enable a tenant to ‘reject’ the office leases it no longer needs. Among other things, the Bankruptcy Code is designed for the purpose of recalibrating a business’ obligations.

If the tenant in consultation with its attorney has concluded that a pre-planned bankruptcy filing is something it is prepared to consider, the tenant may find the landlord(s) willing to cooperatively restructure and/or terminate the surplus office space lease(s), rather face the potential impairment of their contractual rights under the Bankruptcy Code and incur the cost and distraction of bankruptcy proceedings.

Tenant bankruptcy. ‘Rejection’ of an unexpired lease under section 365 of the Bankruptcy Code constitutes a breach of the lease relating back to the date immediately preceding the filing of the debtor’s bankruptcy petition.

A claim resulting from the rejection of a lease becomes a prepetition unsecured claim which must be presented through the normal claims administration process. Such claims are frequently paid out in tiny “Bankruptcy Dollars” which may be a small fraction of U.S. Dollars that are actually owed under the lease.

Bankruptcy Code section 502(b)(6) provides a cap on such claims by landlords for damages under long-term real property leases. Businesses such as retail chain stores often file reorganization cases under chapter 11 of the Bankruptcy Code in order to take advantage of this cap when closing unprofitable locations. These cases generally involve insolvent entities that are facing many difficult financial issues and challenges.

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The Section 502(b)(6) cap is designed to limit lease rejection claims to prevent landlords from receiving a windfall at the expense of other creditors. Depending upon the length of a lease, the landlord’s claim for future rent could be enormous and dramatically diminish the return to other unsecured creditors.

Section 502(b)(6) limits the claim of a landlord for damages resulting from the termination of a lease of real property to the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years of the remaining term of such lease.

It’s important to note that most chapter 11 debtors are insolvent. However, when the tenant debtor is solvent and files a chapter 11 petition in order to use section 502(b)(6) to cap its sole landlord’s claim — and thereby enhancing the recovery of the debtor’s shareholders (as opposed to its creditors) — courts have struggled with the application of the good faith doctrine underlying bankruptcy cases.

In chapter 11 cases involving multiple leases, the issue is less likely to arise since these cases will involve more than just a two-party dispute, and there is a greater likelihood of more complicated financial issues and problems.

It’s worth noting that in *In re Integrated Telecom Express, Inc.*,¹ the debtor commenced a chapter 11 case in order to take advantage of

the section 502(b)(6) cap. The debtor had ceased business, had no intention of reorganizing, had sufficient assets on hand to pay all claims, and was in no financial distress at the time of filing.

The Third Circuit found there was no bankruptcy purpose in such a filing and dismissed the case. Recently, the Third Circuit relied on this precedent in dismissing the initial chapter 11 case orchestrated by Johnson & Johnson to address its mass tort liability.

Landlord bankruptcy. Section 365(h) of the Bankruptcy Code applies to rejection of real property leases by debtor lessors and provides certain protections to lessees. Where the debtor is the lessor, rejection of the lease results in the termination of covenants requiring future performance by the debtor.

Rejection, however, does not divest the lessee of its right to stay in possession. Rather, when a debtor/lessor rejects an unexpired real property lease, the lessee has the option to either consider the lease terminated or may stay in possession of the property for the balance of the current term and exercise any right to extension or renewal.

Under section 365(h)(2), a lessee’s claim for post-rejection damages is limited to an offset of the rent reserved under the lease when the lessee chooses to remain in possession after the debtor/lessor rejects the lease.

The building foreclosure wild card

Many office buildings will change hands in the coming years as the result of lender foreclosure and subsequent sale to a new owner by the lender. If the building is foreclosed, there may be potential opportunities for tenants to terminate or restructure their leases.

If the tenant is one of a few remaining tenants in the building, or the only tenant in the building, the foreclosing lender or the subsequent buyer may want to shorten or terminate the lease so that the building can be closed to reduce current operating costs and/or to prepare the conversion opportunity to another use. If you have options to extend your lease, the tenant may even have some leverage to ask for a lease termination payment.

As the old boy scout motto goes, be prepared.

Both tenants (and landlords) should carefully evaluate and understand their needs, rights and obligations in consultation with legal counsel, in order to know where they want to go and how to get there before starting the journey.

And remember, you’re not alone. Virtually every business that uses or leases office space — both large and small — will be wrestling with this issue for some time to come.

Notes

¹ 384 F.3d 108 (3d Cir. 2004).

About the authors



David Wald (L), president of Wald Realty Advisors, has more than 30 years' experience in commercial, multifamily, tract housing and other specialty real estate. He works with a variety of clients, including public agencies, high net worth families, lenders and state and federal courts. He is based in Los Angeles and can be reached at dwald@waldrealtyadvisors.com.

David Kupetz (R), a partner at **Locke Lord LLP**, has more than 35 years' experience in distressed transactions, crisis avoidance consultation, workouts, restructurings, reorganizations, bankruptcies, receiverships, assignments for the benefit of creditors, creditor rights, and other nonbankruptcy insolvency solutions and related transactions and litigation. He is also based in Los Angeles and can be reached at david.kupetz@lockelord.com.

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