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Commercial Renters Have a New Worry: A Landlord's Default

By ALISON GREGOR

Office landlords have always scrutinized the financial stability of prospective tenants, but now they are finding themselves under the lens.

Prospective tenants are asking for financial statements from landlords, hoping to avoid companies that might default on their mortgages and leave tenants at risk of losing the space. Tenants are also more wary of subleasing space, and are tending to flock to buildings with stable owners.

"We have to be more attentive to the finances of our landlords than we've ever been to get a sense of their financial stability and ability to service their debt," said David N. Feldman, a managing partner at the law firm Feldman Weinstein & Smith, a 12,500-square-foot office tenant at 420 Lexington Avenue near Grand Central Terminal that, with a lease expiring in 2011, will soon start looking for office space.

During the recent era of cheap money that led to the real estate boom, many investors bought their office buildings at high prices with extensive debt, hoping to flip the building quickly. Some landlords

calculated their cash flow too optimistically, intending to lease poorly performing office buildings at high rents to maximize their profit, and are having trouble paying their debt, in some cases falling behind on payments.

"Today, we have this environment where we know that anyone who bought a building in the last few years is at jeopardy of losing that building," said Howard Fiddle, a vice chairman at the commercial real estate brokerage CB Richard Ellis. "So, just from a purely operational perspective, you want to know who your landlord is."

In many ways it is a great time to be a tenant. Rents have dropped by 15 percent or so in Manhattan, smaller security deposits are required, and some landlords are offering free rent for as long as a year and a half.

But tenants also must be wary. Marisa Manley, president of Commercial Tenant Real Estate Representation, said there are reasons for an office tenant to worry about a landlord's losing the building. Money given by landlords to tenants to customize their office space, generally paid as an allowance over a period of time, could

be lost, and in the current market, brokers said that money from landlords could be equivalent to \$70 a square foot. Also, services in the building could deteriorate, Ms. Manley said.

She suggested that tenants demand that landlords offering tenant improvements put the funds in escrow or in a letter of credit, which means they could not be seized in a bankruptcy proceeding.

Protections against declining building services are harder to achieve, but a larger tenant can try to negotiate "self-help rights," Ms. Manley said.

"If the landlord doesn't perform certain duties, you have the right to go and hire someone to do them yourself," she said, and get compensated by the landlord. "These are things like cleaning, and heating, ventilation and air-conditioning maintenance."

Mr. Fiddle said that office tenants could also negotiate the "right of offset."

"Let's say part of the original deal was the landlord had to fund a \$50-a-foot cash contribution toward

tenant improvements,” he said. “And let’s say the landlord paid about \$30 a foot and then went bankrupt. The right of offset means that the additional \$20 a foot could be deducted from the rent the tenant owes.”

Mr. Fiddle said these types of protections did not get discussed much during the real estate boom.

“People know the terminology, but they have to pull it out and dust it off,” he said.

To avoid the aggravation of these highly specialized negotiations, Mr. Fiddle said most office tenants would simply gravitate toward stronger landlords with lower debt on their office buildings.

“What’s basically happening is a flight to quality,” said Frank Mancini, an executive managing director at the commercial real estate brokerage Grubb & Ellis. “But it’s not only quality of space, but quality of landlord or owner.”

Though banks would be unlikely to kick out existing leaseholders on taking over ownership of an office

building, tenants — especially larger ones — should get a nondisturbance agreement from a landlord’s mortgage lender as a matter of routine, Mr. Fiddle said. This means the bank would have to recognize the existing lease of the tenant if it took over the building.

“Any full-floor or multiple-floor tenant will get a nondisturb — it’s almost automatic,” he said. “However, for very small tenants, it’s not automatic.”

Any potential pitfalls for office tenants in the current economic downturn are magnified for those companies seeking to sublease space, brokers said.

“The sublease market has been flooded with space, and most of these are fantastic spaces,” said Ruth Colp-Haber, a founding partner at Wharton Properties, a commercial real estate brokerage. “However, if you look at the profile of the average sublandlord, they’re putting space on the market because they’re having financial difficulty. Therefore, some type of lease default, and maybe even bankruptcy, is very conceivable.”

Ms. Colp-Haber said that companies that sublease space could protect themselves by negotiating the right to stay in the space with the building’s landlord if the sublandlord should default.

To avoid the perils of subleasing office space, the CRG Partners Group, a turnaround consulting business, is seeking to leave its subleasing situation at 711 Third Avenue at 45th Street for a direct lease, said Timothy J. Lewis, a partner with the firm.

The New York office of the firm, which assists businesses in financial trouble or in bankruptcy, has been growing rapidly in recent months. Given the company’s line of work, Mr. Lewis said CRG was especially careful about evaluating the financial stability of landlords.

“We’re certainly aware of the risk, so we’re probably a little bit more careful,” Mr. Lewis said. “If we decided to go the sublease route, we’d vet the financial condition of the lessor pretty closely, and partly for that reason, we’ve decided to try and do a direct lease.”