Portfolio Media. Inc. | 111 West 19th Street, 5th floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

4 Considerations For Landlords Amid Rise Of Co-Working

By **Andrew McIntyre**

Law360 (February 12, 2020, 5:59 PM EST) -- Amid increased demand for co-working environments, WeWork and similar companies have taken massive amounts of space across the country, and lawyers say such lease deals can be lucrative for landlords. But owners should keep several key points in mind as they consider leasing to a co-working company.

Co-working tenants present a unique set of privacy issues for landlords, and experts say lenders may also be more hesitant to provide financing for buildings knowing that co-working companies will be or are occupying some or all of the space.

“On the one hand, for a landlord or an owner, it’s a great way to maximize the space,” said Amy Altshuler of Lewis Roca Rothgerber Christie LLP. “But there are risks and issues … that you wouldn’t ordinarily have if you were leasing to an office tenant.”

Here, Law360 looks at four considerations for landlords who are already in the co-working space or are considering bringing a co-working tenant onboard.

Occupant Mix Is Key

Companies that own large portfolios are constantly monitoring what their tenant mix looks like, and lawyers say it’s important for landlords to ensure they have a mix of tenants across a variety of sectors, in order to minimize risk.

Tony Natsis of Allen Matkins Leck Gamble Mallory & Natsis LLP said the question is not necessarily whether to lease to a co-working client, but what percentage of total portfolio space co-working companies should take up.

“Some clients won’t do them at all. Some will do them,” Natsis said.

WeWork has been in the news of late for **pulling its initial public offering** last year and then laying off 2,400 employees, which can’t exactly instill confidence in landlords when it comes to the co-working sector.

And lawyers say landlords’ decisions to rent to co-working companies are also partly based on the market and the type of property.

“It depends on how desperate your owner-landlord is,” Altshuler said. "Sometimes you’re converting what used be an old mall with big-box spaces, and you’re thrilled to death to make it work. But if you’re in a really hot market, as an owner, you might say, 'WeWork doesn’t really work for us."

But the underlying concern is a question of the viability of the co-working model, particularly given WeWork's troubles in 2019.

"Nobody really knows how viable these co-working companies are," Altshuler said. "Landlords might think, 'We've got this great company that's going to take up floors one to three.' And then [the co-working company] goes bankrupt."

Privacy Is Paramount

Co-working spaces generally use open floor plans with few interior walls, which lawyers say can create a whole host of privacy, security and confidentiality concerns.

Simply put, there is generally very little privacy in such setups, and the landlord could be held liable if an issue arises.

"If there were a theft of information or trade secrets, one small company steals the next big idea from another company, there's significant liability to pass around if you don't have good clauses about security and access in the lease," said Edward McNicholas of Ropes & Gray LLP. "For small companies whose value stems from developing [intellectual property], co-working space can present … challenges in keeping desks clear and keeping presentations confidential."

Indeed, part of the challenge, lawyers say, is that it's difficult to know just who has access to the space, and controlling that can be tricky. Part of the onus also lies on tenants.

"It's the philosophy of keeping your desk clean at the end of the day … and worrying about who else is in the space and might have access," said Robert McPeak of McDonald Carano LLP.

Developers are also increasingly looking at layout as they build new properties that may be leased to co-working spaces. The question is whether or not to go with the open floor plan model.

"You have individuals doing lots of different things. There may be confidential information that shouldn't be shared," Altshuler said. "When building out these spaces, it's a consideration."

Lenders May Do Tighter Underwriting

Landlords need to make sure they'll be able to get whatever financing or refinancing they'll need if they have a co-working tenant at the property, and lenders will more closely scrutinize loans if such a tenant is at the building, lawyers say.

Lenders are concerned about cash flow, and the co-working model generally doesn't have the same long-term cash flow as that of a traditional office lease, which makes loans more complex.

"The biggest thing that we see when it comes to co-working, both for landlords and lenders, is the underwriting," said Daniel Stanco of Ropes & Gray. "Traditional real estate relies on steady cash flow and long-term obligations. … That's what's underwritten."

For example, landlords now are sometimes hiring companies to run a co-working operation at the property on the basis of a revenue-sharing agreement rather than a traditional lease. But that means there's no fixed amount of rent for lenders to use when underwriting, Stanco said.

McPeak said lenders often take second or third looks at loans for properties when they know co-working companies will be using them, in an attempt to better under understand the cash flow question.

"Any building that has more than 30% occupancy by a co-working company, [lenders] tend to view it as having less value," Stanco said. "It's more of a speculative investment. Therefore, lenders will underwrite that to a discount."

In response, landlords are now also starting to require clauses that could shift certain lease liabilities to a parent company, whereas before leases were often done without the requirement of such guarantees, according to Jack Creedon of Ropes & Gray.

But at the end of the day, lenders also share the concern about tenant mix that landlords have.

“A lender … is worried about having a tipping point, having too much co-working occupancy,” Natsis said.

There May Be Use Issues

Owners also need to do a careful analysis of the use provisions at their properties, since co-working doesn’t fit into a neat box like office or retail, and bringing on co-working tenants could cause major use issues.

As more and more buildings become mixed-use, often with retail on the ground floor and office space above, the question of use is more complex if a co-working company is taking space in the building, experts say.

Landlords “don’t know who [the tenants are] going to be when they negotiate these leases,” Altshuler said. “The issue to consider is you may have prohibited uses that you’re going to run into."

Altshuler mentioned coffee shops, yoga studios and lunch kiosks as shared amenities that could see issues if a co-working tenant signs on. Part of the problem is that co-working is unpredictable in terms of the number of employees who will be in the space and the times during which those employees will be working, which can upend what would otherwise be a more predictable stream of customers to such establishments.

And the issue could also reach across to nearby buildings, since neighboring properties may share certain common areas or amenities with the landlord's building.

“It can cause real issues between you and your neighboring property owner. That comes up … with shared amenities,” Altshuler said. “There’s a big push and pull there. There’s a real difficulty in controlling the uses."

--Additional reporting by Tom Zanki. Editing by Alanna Weissman.
