

REAL ESTATE ALERT

AKIN
GUMP
STRAUSS
HAUER &
FELD, L.L.P.



A GLOBAL LAW FIRM FOR THE 21st CENTURY

MARCH 2000

LEASING TO HIGH-TECH TENANTS—NEW LEASES FOR THE NEW ECONOMY

Lines of business that did not exist a few years ago (or in some cases, a few months ago) have moved from the garage, basement or other similarly modest locations into leased space more responsive to the needs of their high-tech occupants. In that process, such tenants have become an increasingly powerful force in the real estate marketplace. Interestingly enough, many landlords continue to try to use their old form leases to respond to the space needs of start-up as well as more mature high-tech enterprises. Unfortunately, many high-tech tenants therefore sign leases that are not particularly responsive to their needs; as a result, such leases have the potential to cause the tenant great surprise and disappointment, often at a time when the tenant is on the verge of an important milestone in its business plan. Landlords too may suffer from failing to consider the needs of a new class of tenants, and landlords who do not recognize the distinctions between the needs of a high-tech tenant and other tenants will soon find themselves at a competitive disadvantage with those landlords who do.

This article identifies some of the many lease issues that may be unique to the high-tech tenant – particularly the high-tech startup – in order to assist the tenant in addressing such issues as part of its lease negotiations and the landlord in anticipating such matters when proposing or negotiating a lease with a prospective tenant. In addressing these issues, this article assumes that many of the basic lease provisions,

such as casualty, condemnation and rent, will generally be treated as in the more typical lease and “tweaked” as required. Therefore, this article addresses only those lease provisions for which special treatment or consideration might be required. Accordingly, the following are areas that both landlords and their high-tech tenants should specially consider when drafting and negotiating a lease.

Description of Premises

The parties should consider not only the typical description of the portion of a building to be leased by the tenant, but also the tenant’s ancillary needs, such as space for the location of an auxiliary power generator, or rooftop or other space for the location of a satellite dish. Landlords have become increasingly cognizant of the value of rooftop space, and the tenant should anticipate that the location of its satellite dish on the roof of a building might require the payment of additional rent to the landlord. If a generator or satellite dish is located on a pad at ground level, the landlord might also request additional rent, and the tenant should consider the security issues inherent in locating the facilities outside of the building.

Lease Term

In considering the term of lease, the tenant should anticipate success but provide for the possibility of failure. While the tenant’s initial space requirements may be modest, the tenant should, especially if it anticipates investing its own money in tenant improvements, provide for growth and expansion. Additionally, in the event all does not go as planned, the landlord and tenant should consider a strategy

for unwinding the lease transaction. In analyzing the landlord's needs in lease termination provisions, the tenant should consider the amount of tenant improvements the landlord is providing as well as other inducements (e.g., free rent) and the landlord's other costs and expenses of effecting the lease transaction (e.g., brokerage commissions paid by the landlord). The tenant should also consider the amount of time the landlord will require to relet the space in the event the tenant leaves the premises prior to the anticipated expiration of the term. Since many of the costs associated with the landlord's leasing of the premises, such as brokerage commissions and tenant construction allowances, can be amortized over the lease term, a tenant considering the establishment of a termination payment should be aware that such items typically "burn off" as the lease matures.

While there are numerous variations to termination rights, including rights with respect to less than all of the premises, a tenant and landlord might address such rights by providing specified dates upon which the tenant may exercise a termination right upon the payment to the landlord of a predetermined amount. This will help satisfy the tenant's possible needs for early termination, while at the same time providing a certainty to the landlord that it will be entitled to recoup a predetermined amount in the event the early termination of the lease is effected by the tenant. The tenant should anticipate that if it is proceeding in a termination mode for less than all of the premises, the landlord may very well require that expansion options and possibly renewal options no longer be available to the tenant.

Security Deposits

Currently evolving in the market, security deposit issues are among the trickiest areas of lease negotiations between first-stage technology companies and their landlords. Providing assurances to the landlord that a tenant, especially one with a very short operating history and quite possibly no history of returning a profit, is going to be able to pay the agreed-upon rent for the entire term of the lease may be a challenge.

While there are reports of landlords taking equity interests in start-up companies in lieu of rent, such actions do not appear to be widespread at present. Even if a landlord wishes to take equity in a tenant that might not otherwise qualify to lease space, landlords often are subject to lease guidelines and criteria established by their lenders, who usually are less entrepreneurial than are landlords. Furthermore, the tenant should be aware that early equity is often very expensive equity and perhaps should not be used for office space, which might be characterized as a relatively fungible commodity, and instead saved for those parties providing the capital and vision for the tenant's growth. Finally, the early stage start-up tenant should be very wary of a landlord that demands equity with anti-dilution provisions.

Traditional methods utilized by high-tech start-ups to assuage landlord concerns have included providing letters of credit, cash security deposits and third-party guaranties issued by creditworthy individuals or entities. If using a letter of credit or guaranty, the tenant should propose to the landlord that as the term of the lease progresses, and the landlord's exposure for the tenant's default decreases (by virtue of the amortization of the landlord's expenses incurred in leasing the space to the tenant), the amount of the letter of credit or the amount of the guaranty should also decrease. Additionally, a tenant using a letter of credit should consider its own business cycles, as the landlord's typical letter of credit security deposit clause will provide that the letter of credit, if not issued for the entire term of the lease, must be renewed (often annually). If the credit issuer's declaration to the landlord indicates that the issuer does not intend to reissue the letter of credit, this will constitute a default under the lease unless a replacement letter of credit is issued by another financial institution of like or similar strength. In those instances where the tenant's business is cyclical, the tenant should avoid forcing the issuer of the letter to evaluate the tenant's financial condition at a time that may be less than optimal, thus precipitating a decision by the issuer not to reissue the letter of credit.

Some start-ups have successfully convinced landlords to lease them space based upon a disclosure of the companies with which the tenant is working and/or those venture capitalists involved with the company. The reputation of such companies and venture capitalists may be important to the landlord's determination of the viability and future creditworthiness of the tenant.

Finally, if a guaranty or letter of credit is used as a means of providing security to the landlord, the tenant should explore the elimination or at least the reduction of such items if the tenant reaches a pre-established financial benchmark.

Tenant Alterations and Landlord Allowances

It is not uncommon for a landlord to propose granting various inducements to a prospective tenant, such as periods of free rent and/or the payment of monies to the tenant for the construction of the tenant's improvements within the demised space. Typically, the initial improvements constructed by or on the behalf of the tenant, as well as any subsequent alterations, are subject to the landlord's approval; however, tenants are often able to obtain a concession from the landlord that non-material alterations to the premises (e.g. painting, recarpeting, etc.) do not require the landlord's consent. The technology-based company should also include within that list recabling all or a portion of the premises.

The interests of the landlord and high-tech lessee may diverge in connection with the landlord's idea of what it is getting for its construction dollars and what the tenant anticipates it will need for the operation of its business. For example, if a landlord is accustomed to providing tenant allowance dollars for typical office improvements, but the tenant anticipates an open floor plan and minimal finish levels but very high per-square-foot cabling and other technological costs, the tenant might encounter some resistance from the landlord. Therefore, the parties should determine early in the negotiations if there are going to be any limitations on the types of improvements that may be funded from the construction allowance.

Heating, Ventilating and Air Conditioning

Where the landlord has agreed to maintain certain heating and cooling levels within the leased premises, such obligations are typically conditioned upon the tenant having no more than a specified number of people within the space, as well as the tenant undertaking certain heat abatement procedures, such as keeping blinds drawn at a specified angle or providing window treatments that reduce the heat load within the premises. In a calling center, a tenant may very well exceed the normal office level of employees per square foot, and should consider whether the air conditioning units will need to be upsized or supplemental units will be required, and if so, at whose cost. These issues are more easily addressed in the design phase of the premises than at a later date. Additionally, the tenant's architect and engineer should consider electrical load requirements to the premises, as landlords may be concerned about a tenant overburdening the electrical system in the building and may impose a restriction based upon watts per square foot contained in the premises.

High-tech companies are well-known for their extended hours of operation. The traditional lease might very well contain a standard provision that provides, as part of the rent, that the landlord will provide heating and air conditioning during specified hours of operation, perhaps 8:30 a.m.-6:30 p.m. weekdays, with some designated hours on Saturday and no services on Sundays or holidays. Such leases typically provide for the provision of such services at other hours subject to an after-hours service charge that may, in part, end up as a profit center to the landlord. The tenant whose hours of operation extend beyond those for which the landlord might be accustomed has several options. One option is to make sure that in the design of its facilities, the tenant has individually dedicated air conditioning and heating facilities that are separately metered, so that the cost for the operation of such items may be paid directly by the tenant, and the premises operated at such hours as the tenant finds convenient without the burden of overtime HVAC charges.

If parking is provided, the tenant should consider during what hours the landlord will be obligated to provide lighting and security. The tenant should be aware that the landlord might seek to recapture from the tenant the cost of extra hours of lighting and security either through a direct reimbursement from the tenant or by making such costs part of a common area charge.

Assignment of Lease

The typical assignment clause in a landlord's lease form often prohibits any assignment by the tenant without the landlord's consent and includes a "deemed assignment" provision that is triggered by the transfer of partnership, corporate or other similar entity interests in the tenant. This provision can be especially detrimental to a start-up company, as in any of the rounds of funding, ownership in the entity that constitutes the tenant may very well change. The tenant

should seek to provide that as long as such change in ownership renders the tenant in a financial position no less strong than that at the time of the original execution of the lease, the landlord's approval is not required. Failure to address such provisions may very well put the tenant at the landlord's mercy just at the time the tenant is reaching an important goal.

While the foregoing items are certainly not the only issues that should be considered in any lease negotiation, for a high-tech tenant or otherwise, they should serve as a good starting point for the parties in focusing on some of the unique needs and considerations of an increasingly important market sector.

EARL SEGAL is a partner in Akin, Gump, Strauss, Hauer & Feld, L.L.P.'s real estate and finance practice and is a frequent author on real estate-related topics.

IF YOU WOULD LIKE TO LEARN MORE ABOUT THESE ISSUES, OUR FIRM
OR OUR PRACTICE IN THIS AREA, PLEASE CONTACT:

EARL L. SEGAL

PHONE: (202) 887-4160

E-MAIL: ESEGAL@AKINGUMP.COM

AKIN, GUMP, STRAUSS, HAUER & FELD, L.L.P.

ATTORNEYS AT LAW

1333 NEW HAMPSHIRE AVENUE, N.W.

WASHINGTON, D.C. 20036

PHONE: (202) 887-4000

FAX: (202) 887-4288

PLEASE VISIT OUR WEB SITE AT WWW.AKINGUMP.COM

©2000 AKIN, GUMP, STRAUSS, HAUER & FELD, L.L.P.

ALL RIGHTS RESERVED