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Special Leasing Considerations for Tech Companies

Mimimize risks by negotiating key protections into the lease

By Julie Ann Boas

While any prospective tenant of office space must pay careful attention to myriad issues and potential liabilities and pitfalls, businesses in the technology sector should take into account special considerations when leasing office space. Many such businesses are so-called "start-up companies" and recent history suggests that, over the course of a lease term, such companies will likely need the ability to expand or contract physical operations or to enter into transactions that would result in a change of control or corporate form, including a sale of the business. These companies, in leasing and planning space, also need to pay careful attention to any personal liability for lease obligations, site selection, the cost and ownership of leasehold improvements, electricity and wiring needs and capabilities, sublease and assignment rights (including with respect to "corporate-type" transactions), security and insurance. This article will enumerate specific points that should be considered when a technology company is negotiating a lease for new office space.

Most landlords will require that a tenant post a security deposit as a condition to entering into the lease. A typical security deposit is an amount equal to rent reserved under the lease for a period of anywhere from one to 12 months, which the landlord may generally draw down upon the tenant's failure to perform any of its obligations under the lease. Because of the real or perceived risk that a start-up company will fail to pay rent at some point during the lease term, it is not unusual for landlords to require start-up companies to post security deposits at the higher end of the spectrum, in the six to 12 month (or sometimes longer) range. Paying a larger security deposit is likely to be impractical for a start-up company, either because the funds are not available or because the funds could be better deployed elsewhere.

A landlord might require the principals of a technology company to personally guarantee payment of rent and performance of the tenant's nonmonetary obligations under the lease. The latter, if within the scope of the personal guaranty, would include any repair obligations and any obligations to remove personal property, equipment, trade fixtures and leasehold improvements at the expiration or sooner termination of the lease term.

The "good guy" form of personal guaranty is frequently used in the leasing context. As the name implies, the guarantor is rewarded for cooperating with the landlord. Typically, the guarantor's obligations will run only through the date that the guarantor causes the tenant to fully vacate and surrender the leased premises to the landlord as required under the lease, in many instances provided that the payment of rent is current through such date.

A technology company can minimize the burdens placed on it and its principals by negotiating the right to post a standby letter of credit in lieu of either a cash security deposit or a personal guaranty (good guy or otherwise) of lease obligations. The cost of a standby letter of credit may be minimal as compared to paying a security deposit and losing access to funds that are need-

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ed for operations in the start-up phase or beyond, so long as the technology company (or a principal thereof) is able to post collateral to secure the tenant's obligation to repay any amounts advanced by the issuer of the standby letter of credit. In addition, the right to substitute a standby letter of credit for a personal guaranty (which would then be released), if exercised in conjunction with the sale of the business or otherwise with respect to an assignment of the lease, will enable the guarantor to manage the risk of future liability after selling its equity interest in the business.

A technology company should take into account its data room requirements when selecting space and negotiating a lease instead of waiting until a lease is in place. There are practical considerations that could render an otherwise ideal space unsuitable for a technology company if there is no appropriate location for a data room. A data room ideally will not be constructed in ground floor space, to avoid the risk of flooding, or on a top floor or beneath plumbing fixtures, to avoid the risk of leaks. Selecting a room without exterior walls might be a factor in efficient temperature control. If possible, especially if the lease will be for a relatively long term, the data room should contain extra space or be adjacent to space into which the data room could be expanded should the need for additional equipment arise. It will be easier and more cost effective to create an opening into adjacent space than it will be to entirely reconstruct a data room in an alternate portion of the leased premises.

The actual data room needs to be large enough to accommodate a raised floor, cabling, supplemental air conditioning and ventilation ducts and equipment, server racks, and access routes surrounding the server racks and equipment. A raised floor enables air flow beneath equipment and creates space for air conditioning equipment and wiring. Supplemental air conditioning will likely be needed in the data room to protect heat-sensitive equipment. From a technical standpoint, it is critical to confirm that the floor load capacity in the data room is sufficient to support a raised floor and all of the equipment that could be installed in the data room over time, including, potentially, a back-up generator or other uninterrupted power supply, and that the space will support any necessary wiring and ductwork.

It is advisable for a tenant with such requirements to negotiate construction terms in the lease. If plans and specifications cannot be completed during the lease negotiation phase then, at a minimum, the lease should provide that the landlord will not unreasonably withhold, condition or delay its consent to leasehold improvements even if they affect building systems (so long as there is no adverse effect to same). This could be a point of contention with the landlord, because the landlord will likely want outright discretion to approve or not approve such changes. However, a technology company needs assurance that it will be able to use space for its intended purpose prior to committing to a lease.

The lease must address whether the landlord or tenant is responsible for the cost of leasehold improvements and equipment and which party will actually own such leasehold improvements and equipment. The lease should also indicate whether leasehold improvements will include any building systems located beyond the interior walls of the leased premises. Depending on market conditions and the rental rate to be paid by the tenant during the term of the lease, the landlord may offer a construction allowance, which likely will be based on the square footage of the leased premises. It is important to clarify in the lease whether the construction allowance can be used only for so-called "hard" construction costs or also for so-called "soft" construction costs such as architect's and consultant's fees, and perhaps even for certain furniture, fixtures and equipment.

If the tenant is purchasing sophisticated and expensive equipment to be used in the leased premises, then it is essential to negotiate a provision in which the landlord, first, affirms that the tenant will retain all right, title, and interest in and to such equipment, including the right to remove such equipment from the leased premises at any time prior to or upon expiration or early termination of the lease, and, second, waives any lien (or other form or right of distraint) that the landlord might otherwise have on the equipment. Failure to include these points in the lease could negatively impact the tenant's ability to obtain the necessary financing to purchase the equipment in the first place. However, if leasehold improvements are incorporated into the realty and stated to be the property of the tenant, the lease may be more likely to burden the tenant with responsibility for restoration in the event of casualty and removal of the leasehold improvements (including wiring and cabling in connection therewith) at the end of the term, both of which are potentially significant costs.

The lease must also address whether the landlord or tenant will actually perform or oversee the performance of leasehold improvements in the leased premises. A technology company particularly, assuming that it is responsible for installation of equipment in the data room and wiring throughout the leased premises, needs to ensure in the lease that it will have an opportunity to install the equipment and wiring at the appropriate times prior to the commencement of the lease term and its obligation to pay rent. If the installation must be performed in whole or in part before the landlord completes finishing touches on the leasehold improvements, as is likely, then it is important for the lease to provide that the tenant will have access to the leased premises for purposes of installing equipment and wiring during such time period. The need to coordinate construction schedules, which the landlord might resist, is eliminated if the parties agree to make the tenant responsible both for oversight of leasehold improvements and installation of equipment and wiring.

A technology company's servers, supplemental air conditioning system,

back-up generator or other form of uninterruptible power supply, lighting fixtures, and other equipment could require greater amounts of electricity than would otherwise normally be made available to the leased premises for a more traditional office tenancy. It is important for a technology company to consult appropriate professionals regarding building capability and necessary modifications. If it is determined that the building can support the technology company if certain modifications are made and that the cost of such modifications will either be borne by the landlord (either as part of the construction allowance or directly) or can be absorbed into the tenant's project budget, then it is necessary to memorialize which party will make such modifications, which will likely, if it is to be the tenant's responsibility, require access by the tenant to the office building's risers prior to the lease term.

A technology company must also consider the cost of electricity during the term of the lease in determining whether use and occupancy of the leased premises will in fact fall within the technology company's budget. There are multiple methods for passing the cost of electricity through to a commercial tenant. Some landlords do not attempt to differentiate between tenants with greater or lesser electricity needs and instead include electricity delivered throughout an office building (and not just to common areas) in operating expenses to be paid by tenants in amounts proportionate to the area of their respective leased premises. Unless all tenants have similar electricity requirements, this method is unfair. Some landlords insist on a lease provision that permits them to conduct a survey of a specific tenant's electricity usage and increase charges to that tenant based on findings of the survey. A survey of a tenant's electricity usage poses some risk to a tenant in that the tenant's costs for electricity could increase at an unpredictable rate, which, in the absence of metering, might not be fair to the tenant. As a result, a tenant that cannot avoid a survey provision should, at a minimum, have the right to challenge the findings of an electrical consultant retained by the landlord by presenting the findings of its own electrical consultant.

Some office leases provide that a tenant will pay for electricity based on a rent inclusion factor per square foot. In such event, the tenant will know its cost for electricity when negotiating the lease because the cost will be a set amount based on the square footage of the leased premises. However, a lease could provide for an increase in the rent inclusion factor based on a survey of the tenant's electricity usage, as discussed above.

Finally, depending on the set-up of the office building and the size of the leased premises, a tenant might pay for electricity based on a direct meter or on a submeter. A tenant with a direct meter has the benefit of a direct relationship with the electricity provider and, therefore, will have control over charges. A tenant whose charges will be based on a submeter needs to negotiate specific language in the lease to prevent the landlord from charging inflated electricity rates and/or unreasonable management or add-on fees.

Technology companies leasing office space in the start-up phase may have difficulty determining how much space will be needed over the life of a lease term. Outgrowing office space can leave a tenant in the uncomfortable position of having to relocate its business. One solution is to negotiate in the original lease a right of first refusal or a first right to negotiate on space adjacent to or on the same floor as the original leased space.

Another solution is for a technology company in its start-up phase to lease more office space than it originally needs but that it anticipates growing into during the term of the lease. In that situation, the tenant needs to provide that it can recoup some of its investment in the lease by negotiating a provision that permits it to share space with or sublet space to unrelated companies without consent from the landlord.

Most commercial leases provide that the tenant cannot assign the lease or sublet the leased premises without the landlord's prior written consent. Depending on how the lease is negotiated, the landlord might either be permitted to withhold consent in its sole discretion or the landlord may not be permitted to withhold consent unreasonably. A technology company should not make the mistake of assuming that the sublease and assignment provisions are unimportant just because it intends to remain in the leased premises for the entire term. Such provisions can also impact the ability to obtain financing for, or even to sell the technology company.

Leases frequently provide that a change in control, or even any change in equity interest in the tenant entity, constitutes an assignment requiring the landlord's consent. In response, to ensure that the lease will not limit the tenant's ability to raise capital later on, the tenant should negotiate for deletion of or exception to these provisions, including, at a minimum, an exception for a public offering or trading of the tenant's stock on a nationally or internationally recognized exchange or on the NASDAQ over-the-counter market and for the private placement or other raising of funds to be invested in the tenant entity for future expansion or additional working capital, including raising funds by selling less than a controlling equity interest in the tenant entity. The public offering and/or private placement exception is also important for preserving the tenant's right to sell its business, as is negotiating an exception for the sale of all or substantially all of the assets of or equity interest in the tenant entity and for the merger, consolidation, or reorganization of the tenant entity.

A technology company will more than likely need to restrict access to its data room. Leases typically provide that the landlord may enter the leased premises during normal business hours and other reasonable times upon prior written notice to the tenant, or at any time without notice in the event of an emergency. Any tenant should insist on the right to be present during any non-

emergency entry by landlord, but this is not practical in emergency situations. Therefore, a technology company should consider installing an electronic access card system for entry into the data room. Doing so will protect sensitive equipment from outsiders and will also ensure that only select employees of the tenant have access to the data room. Punch code systems should be avoided, because the security of the data room will be compromised if the codes are shared with people who are not supposed to have access to the data room.

A technology company should consult with its insurance agent to determine that it is obtaining adequate insurance to protect the business it will be operating in the leased premises. Insurance requirements imposed on the tenant pursuant to the lease might not be enough. In particular, a technology company should consider the need to insure the data room equipment that it owns and on which it relies for its day-to-day operations. A technology company should also consider whether to purchase business interruption insurance to protect against loss in the event of failure of equipment in the data room.

Technology companies face many risks in the start-up phase and beyond. However, much of the risk associated with leasing office space can be minimized by selecting appropriate office space and negotiating certain protections into a lease. When such protections are in place, a technology company and its owners will be better able to manage personal liability, get the best use out of a data room and protect sensitive equipment, manage its costs, including electricity costs, expand the business, including through new financing, and even sell the business. ■