Publications
February 28, 2017

It's Not Only About Dogs, Picnic Tables And Bikes: Leasing Issues For New And Emerging Companies

It's no secret that not all tenants are created equal. However, as some older, more traditional companies fade away, outsource work to other countries or consolidate their operations, a new breed of office tenant is taking their place. This wave of new and emerging company tenants, many of whom are technology companies, are not necessarily better or worse tenants than their predecessors. However, they often do have different needs and expectations. These tenants may have big and exciting plans for their new office space, including creating innovative and trendy areas for their employees, but what they don't know is whether or not their lease permits them to do these things. These tenants may be graphing potential changes to their business and growth but failing to think about how those changes will affect their physical space needs. New and emerging companies need a little extra guidance and focus in order to negotiate a lease that will work for both their current and future needs. Often these types of tenants may be excited about a high-demand space opening up in the trendiest area of a city and eager to get the lease signed so that they can move in and get going with all of their exciting plans for the company; however, there are many reasons why, in order to best help these tenants, it may make sense to put the signing on "pause" and take some time to talk through some of the lease terms that may end up restricting their plans or saddling them with potential liabilities they had not considered. Below are a few of the lease provisions that a new and emerging company tenant (or landlord leasing to such a tenant) may want to specifically consider. **Click here to download: Quick Checklist for Emerging Company Leases.**

Permitted Use

The use provision of a lease limits how a tenant may use and occupy its space. The lease generally lists permissible uses of the space (e.g., "general office use only"). This one may seem like a no-brainer -- "General Office Use" should work, right? However, what if the tenant plans to use the space for research and development or a showroom? What if the tenant negotiates the right to sublease the entire premises (see Assignment/Subletting below) or even a portion of the premises? Would the description "General Office Use" cover research and development or a showroom or the potential use by the subtenant? Further, some leases provide that the permitted use is the "business" of the specific tenant only. But, what if that business changes over time as this new company evolves? Will that new use be covered by this provision? An overly restrictive use provision could create a conflict with the actual use of the space by the tenant (and create a potential default) as well as make the space harder to market. We often advise these types of tenants in particular to ask for as broad as possible definition of permitted use in the lease: e.g., "anything permitted by applicable zoning", "any lawful office use" or "any lawful use". If the landlord wants more specified limits on the scope of the use as written in the lease, it is important to discuss this issue frankly so that both sides clearly understand and agree to the current and potential operations at the premises.

Another risk for the tenant is that its use of the space may also be limited by the building's certificate of occupancy, local building and health codes and/or applicable zoning laws. This due diligence determination (to determine if a proposed use is permitted) is often the tenant's burden, but first, the tenant needs to be aware that this due diligence is required. A failure to fully consider and think through the proposed uses for the space and then clarify that these uses are permitted under the lease as well as applicable laws, could render the lease an expensive liability to a tenant who cannot use it as it had intended.

On a related note, it may be important to understand the operational hours of the building and to clarify when the tenant's employees can have access to the space and/or related parking areas. Tenants may want to be able to have their employees stay late or come in on weekends, as needed. The work day for their employees may not be 9-5 and the work week might not be Monday through Friday. The lease should allow the tenant to: (a) use the building's common facilities; (b) specify how the tenant's employees, guests or customers may use the space; (c) permit access 24 hours a day, 365 days a year; and (d) state the standards and costs for such overtime uses, if any.

Assignment/Subletting

A tenant's business may grow, contract or dissolve, and its lease should contain exit strategies to allow for these possibilities. The assignment and sublease provision provides a tenant with one exit strategy from the lease by allowing a tenant to transfer its rights to the space to a new tenant during the lease term. However, it is typical for leases to restrict a tenant from assigning the lease or subleasing without the landlord's consent. Landlords are understandingly wary of tenants they do not know and whose financials they have not verified. Thus, this exit strategy may not be an automatic right and may often need to be negotiated with the landlord.

In addition, an assignment issue that tenants often overlook is a prohibition on assignment as part of a corporate restructuring, sale or merger without the landlord's consent. Tenants may not initially perceive these events as relevant to a lease. However, lease forms often provide that assignments to affiliates, changes in control, assignments of interest in the company or a merger or consolidation are deemed assignments that require the landlord's consent. These restrictions can be a major thorn in the side of the tenant, when, at the 11th hour of its public offering, sale of the company or merger, change of ownership structure, etc. -- all of which are common occurrences for new and emerging companies -- it suddenly is brought to its attention that the transaction requires the landlord's consent. To avoid these pitfalls, the definition of what constitutes an assignment should be discussed carefully with the tenant and examined against the tenant's potential plans. Further, a tenant must also be aware that many leases grant the landlord the right to recapture the space when a tenant proposes an assignment or sublease and the landlord elects not to grant its approval. Even if a landlord will not agree to except out certain of these transactions from the definition of an assignment, it is important that the tenant at least recognize these issues so that it knows when it will need to take the landlord's consent into consideration, as well as factor in the potential risk that the landlord could take back the space.

A tenant may also need to assign or sublease its space because it is no longer practical for the tenant's needs either because the tenant has outgrown the space more quickly than anticipated, merged with another company, or down-sized unexpectedly. If there is no other way for a tenant to get out of its lease (see, e.g., Expansion/Extension/Termination Rights below), the tenant may need some right to assign or sublease in order to better absorb the cost of a space that is no longer useful.

It is important to talk through potential future circumstances with the tenant and work to negotiate: (a) the definition of what constitutes an "assignment" requiring the landlord's consent; (b) at least qualified rights to assign/sublease to affiliates (especially if the tenant remains liable under the lease); (c) to sublease or license a limited portion of the space if that is a potential issue to the tenant; and (d) to define the instances in which it would be unreasonable for the landlord to deny its consent (e.g., net worth of the new tenant, type of use by the proposed assignee).

Expansion/Extension/Termination Rights

Flexibility. Flexibility. Flexibility. The one thing that is guaranteed is that new and emerging companies have needs that are constantly changing, sometimes very quickly. For instance, a new or emerging company may need to suddenly double the number of its employees in two years to keep up with unexpected growth. It may expand

the types of products/research in which it specializes. It may merge with a company with headquarters on the other side of town and need to consolidate operations. With considerations like these in mind, such a tenant will want to try to negotiate as much flexibility as it is able (sometimes at the cost of increased rent, which increase may be acceptable to the tenant in exchange for the flexibility). For instance, the tenant can try to negotiate expansion rights in the building for contiguous space or a right to lease a larger or smaller substitute space through a right of first refusal or a right of first offer. These rights should be carefully drafted so that the parties understand the rent payable under these situations, the timing for exercising any such rights and the existence of any superior rights in favor of existing tenants or third parties pertaining to the same space that tenant is considering to relocate.

The tenant can also work flexibility into the term of the lease by negotiating a shorter term lease with extension options (e.g., three (3) one-year extension options). Landlords typically prefer a longer lease term without fixed renewal options. However, it is often in a tenant's best interest to enter into the shortest lease term that the landlord will agree to, while simultaneously retaining the right to extend the lease term in relatively short increments. The issue of a shorter term versus a longer term is often one which requires up-front negotiations in a letter of intent and may require greater rent from the tenant as consideration for the shorter initial term.

Another provision which can provide flexibility is a termination right. Most landlords are obviously less than eager to grant termination rights, but sometimes, if an adequate termination fee is proposed and/or the termination right is limited to either after a certain date or within a specific period of time only, this right can sometimes be obtained for the persistent tenant. Obtaining a termination right for the tenant, even if it can only be exercised by paying a substantial termination fee, may be very important for the tenant because, in the event it cannot assign or sublease its space when needed, a termination right, even when coupled with such a fee, gives the company a known variable to factor into its business decisions. If the landlord will not agree to a termination right, the tenant may at least want to be certain that it can "go dark" or vacate the premises without that act in and of itself being an event of default under the lease. This should not be as big an issue for the landlord in office spaces as it is in retail leases where going dark can dramatically affect the marketability of an entire shopping center.

Parking

Just as a new or emerging company's space needs may change, so might the company's corresponding need for parking. It may be prudent, therefore, to include automatic options for additional parking (including valet, if needed) into the lease at a set price and to include covenants by the landlord that the tenant mix will not suddenly change to allow for higher density tenant use (taking up all of the available parking if non-exclusive). The company may also want to make sure that parking is available 24 hours a day, 7 days a week and that the tenant has some exclusive parking areas located near the building (or covered). These parking areas should be explicitly depicted on a schedule to the lease. The availability of parking, shuttles or access to alternative transportation, including trains or buses, may be an important recruiting point for companies, who often have to compete vigorously for the most talented employees. Parking costs and caps should also be explicitly agreed to when the base rent is negotiated as parking rates in certain high demand tech areas can be extremely expensive.

Tenant Improvements/Surrender of the Premises

New and emerging company tenants often have grand ideas about tenant improvements that they will want to include in their space, such as rock-climbing walls, cafés, vast open spaces, concrete floors, etc. However, leases often provide blanket provisions that tenant improvements are subject to the landlord's approval. Will the landlord approve the stripping of the wood floors or the installation of showers for those employees who bike? Maybe. Maybe not. The problem is, we don't know. Therefore, the tenant should get prior approval for anything it knows it wants to do prior to lease execution. The lease should also provide that the tenant may make certain

non-structural improvements without the landlord's consent, sometimes capped at a certain amount. Of course, the tenant should also make sure that it is able to make such improvements under local building and zoning codes. Typically, due diligence confirmations should be completed prior to signing the lease, though they may require substantial lead time depending on the type of permits or approvals that are required. Alternatively, the tenant could try to negotiate obtaining the required permits and approvals as a lease contingency. The tenant should consider these due diligence and permitting costs in its budget for its proposed improvements. In addition, the landlord may require that the tenant remove all its improvements at the end of the lease term -- this may be a cost that the tenant's accountants may need to track as a liability. If there are any improvements or fixtures that the tenant does not want to retain at the end of the lease term, the tenant should attempt to have the landlord agree that such items can remain upon termination of the lease. Again, clarity as to what liabilities lay down the road is important for the tenant. Alternatively, the lease may provide that all improvements become the property of the landlord and must remain at the premises at the end of the lease term. This may appear to be a better option at first blush, but that assumes the parties will agree on what is a "fixture" versus what is the personal property of the tenant. If there are expensive personalized items or equipment that the tenant has installed and wants to remove at the end of the lease term, the tenant should specify that -- e.g., the tenant should specify that it will remove a custom fan or a high-tech Italian espresso machine that is the tenant's property, even though it may affixed to a plumbing pipe embedded in a wall. Of course, the tenant will be obligated to repair any damage incurred in connection with such removal, as is reasonably practicable.

The tenant should also negotiate who will construct the initial tenant improvements and who will pay for the improvements. Some leases provide that the landlord will complete the build-out work (or a portion thereof) required for the tenant to occupy its space or, alternatively, that the tenant will construct the initial tenant improvements, but that the landlord will reimburse the tenant through a tenant improvement allowance for up to a certain amount to be approved by the landlord upon completion of the build-out. However, tenant improvement allowances are not typically "free". If the tenant will be receiving reimbursement for its build-out through a tenant improvement allowance, this amount is usually repaid to the landlord by an increase in the base rent (the allowance being amortized over the term of the lease). If relying on such a reimbursement, the tenant should be certain to understand the terms of the reimbursement, including any deadlines and requirements to submit invoices to the landlord for reimbursement and to strictly follow the requirements of any tenant work letter, which may provide for various landlord approvals (e.g., approval of the architect, the contractors and the plans and specifications) as the build-out gets underway. Some tenants may be surprised or irritated by the landlord's requirement that it control the build-out of the initial tenant improvements, including the selection of the architect and the contractors and the receipt by the landlord of an oversight fee. Other tenants may be happy to allow the landlord, who specializes in dealing with contractors, to control the process. Whichever party performs the build-out, the timelines and specifications for the approval of the plans should be carefully negotiated. Emerging company tenants often find that their design ideas for their new space change as the build-out proceeds. If that be the case, the right to change the plans and budget and process change orders (and determine how the increased costs are to be managed) also needs to be included in the tenant work letter.

Repairs/Common Area Charges/Landlord Services

It may come as a shock to some tenants, especially those not used to leasing commercial space, that, in addition to the premium rent they are paying for the trendy space in an up and coming warehouse district, they may also have to pay for utilities, their share of common area costs, real estate taxes, the landlord's insurance costs, water, cleaning, elevator service, parking fees, and for the repair and maintenance of much of the tenant's space, including high dollar repair/replacement items such as the heating, ventilation and air-conditioning systems (HVAC). The on-site managers and employees of these emerging companies are often not used to having to deal with (and don't expect to have to deal with) plumbing issues or electrical shorts. While common area expense exclusions, such as exclusions for the landlord's capital improvements to the building (except if amortized over the term of the lease), lending and brokers' fees, etc. can often, and should, be negotiated with the landlord, the

tenant should be made aware of all items for which the tenant is obligated to pay and for what its repair obligations include. It may be prudent for the tenant to request a current or recent operating expense statement so that it can better understand the typical monthly and/or annual common area charges and/or utility costs. A current or recent operating expense statement can also serve as a baseline or "cap" on increases of future operating expenses, so that future operating expenses can be budgeted for by the tenant. Before the lease is signed, it is important for the tenant to have a licensed mechanical engineer inspect the premises and provide the tenant with an estimate of any repairs that might be needed in the immediate future. For example, if any of the HVAC systems is on its last legs, the tenant should require that all replacements costs of that system be the obligation of the landlord (or, for instance, any repairs costing more than 30% of the replacement costs) with the tenant only paying its amortized cost of same (if any). Another option is to obtain the landlord's representations or warranties for certain items, such as the HVAC systems, for at least one year after the commencement of the lease term. Finally, given the frequency of law suits in recent years under the Americans with Disabilities Act (the "ADA"), the tenant should make sure that compliance with the ADA (except for improvements installed by or on behalf of the tenant) is the landlord's responsibility and that any costs, expenses or liabilities in connection therewith are not passed on to the unsuspecting tenant.

Landlord services can also be an issue. The tenant may assume that the landlord will provide certain services, such as security services (including after-hours security), but this may not be the case even if the tenant is willing to pay for the cost of such services. In addition, the landlord may provide certain services for which the tenant is required to pay the landlord that the tenant may have expected to be able to obtain or choose itself, such as janitorial services. These "required" services may not be up to the tenant's standards and/or the charges for same may be higher than market. Services such as janitorial services also can lead to access/confidentiality issues (see Confidentiality below). The services that the landlord will and will not provide (as well as the cost for same and/or the tenant's right to object to same) should be discussed and then clarified in the lease.

Confidentiality

For many emerging company tenants, confidentiality can be a make or break proposition. Their intellectual property rights may be their most valuable piece of property. They typically work very hard to negotiate strict employment contracts that include non-compete and confidentiality provisions. However, they may fail to consider confidentiality issues as they pertain to their landlord's or their agents' access rights. A lease will often state that the landlord is permitted to enter the premises to inspect or repair the premises even when the tenant is not present. When this provision is pointed out to these tenants, they often immediately protest. They may even have a form confidentiality agreement that third-party visitors are required to sign upon entry; if so, the requirement that a confidentially agreement be signed by all third-parties who enter the premises should be explicitly provided for in the lease. The tenant may also want to restrict the landlord's entry into certain designated areas without being accompanied by the tenant, or its representative, and to require advance notice except in emergency situations. It is also important that the landlord agree in the lease, or in a separate confidentiality agreement, to keep the specified information it gains confidential and to indemnify the tenant for any losses or damages caused by such a breach. Landlords may not be used to dealing with tenants who care about access or discarded scraps of paper in a trash can; however, for technology and emerging company tenants, the leak of novel ideas or plans to a competitor can spell ruin for the company. These tenants cannot afford to miss confidentiality and access issues in their leases.

Security Deposits and Letters of Credit

A tenant's creditworthiness is often how landlords determine whether or not (or to what extent) a security deposit is required under a lease. However, for new and emerging companies, creditworthiness may be hard to gauge. The company may have just been formed in the last year. Thus, many landlords require a substantial letter of credit from these tenants in lieu of, or as an alternative to, large up-front cash deposits. Tenants are often

surprised when a landlord asks for a One Million Dollar letter of credit on a five year lease. However, because the landlord is uncertain as to the long-term stability of the company, it needs security for the payment of rent (including tenant improvements which may be amortized over the term of the lease) and other amounts and obligations due under the lease (e.g., repair obligations, compliance with the assignment/sublease provision, delivery of vacant premises at the expiration of the lease term). While this can be a sticking point, a tenant can often get comfortable with this requirement if it can get the letter of credit "burned down" or issued in a lesser amount at different "check points" during the term of the lease. For instance, the amount of the letter of credit may be reduced at yearly or at two-year intervals or it may be released once the tenant improvements, if any, have been fully amortized. Landlords may also require that the issuer of the letter of credit be a national banking institution, have a specified rating and/or have a branch close to the landlord's office (so that the landlord can easily tender the letter of credit for payment if necessary). If the tenant's bank of choice does not meet these requirements, the parties will have to negotiate either different criteria satisfactory to the landlord, or the tenant will have to search for another bank willing to issue a letter of credit. This issue should not be put off until the lease is ready to be signed, but discussed up-front in order to avoid any last minute approval issues with respect to the letter of credit and/or a delay in the lease being signed.

Dogs, Bikes and Picnic Tables (Oh My!)

Okay, so we've come to the stereotype -- that the principals of new and emerging companies are only worried about having dogs, picnic tables and bikes at their leased premises. While, as described above, these companies have a host of issues which are important to them (or which should be important to them), it may come as a surprise to some landlords that these types of issues -- dogs, bikes and picnic tables -- may also be important issues for these types of tenants. It is often the case that new and emerging companies are helmed by younger CEOs. These CEOs and their even younger employees may have a different vision of what the workplace should look like than the last generation to lease space in the building. Their employees may bike to work and may want to make sure that they have a secure place to keep their bicycles (or skateboards). Standard leases often prohibit bicycles in the building. A company may even hope to attract employees based on a bike-able/walkable location. Obviously, a landlord will want to make sure that the tenant is on the hook for any damage to the building and/or the landlord may want to limit bicycles to service elevators or entrances, but a blanket prohibition may not be commercially reasonable or commercially competitive anymore. Likewise, the tenant may want its employees to be able to bring their furry companions to work. Most leases limit the presence of animals to ADA licensed or service dogs. However, dogs and other small animals (even miniature horses!) are being used more and more as "comfort" animals, and in the hope of creating a healthy workplace, a tenant may want to allow certain animals for its employees. This new type of tenant may also want other types of work-place "amenities" that are different than what may typically be permitted by the standard office lease. For instance, it may want to allow the addition of picnic tables outside or the inclusion of a bar or game room. In all of these instances, the tenant should help the landlord re-consider these blanket prohibitions by providing the landlord with reasonable parameters that may make the landlord more comfortable allowing the tenant some leeway in these instances, including by taking on the liability for damage/required permits, as applicable.

The issues to consider for these types of leases are not just an "us versus them" or a "millennials versus older generation" polarization. These new and emerging companies are making up a bigger and bigger share of the marketplace in both traditional office and other locations, such as revitalized warehouse districts, and landlords can gain a lot from being on the cutting edge of the new normal with their properties. On the flip side, these companies often need more guidance than more established companies which have leased space before or whose needs fit neatly into the traditional leasing models. The CEOs of these new and emerging companies may be creative geniuses ready to change the world; however, many of them have no experience in leasing space. The dynamic of having an exciting company with immediate needs juxtaposed against the uncertainty of the company's growth or other changes in the coming years requires a thoughtful and practical approach when it comes to negotiating lease terms. For these types of leases, both the landlord and tenant must communicate

expectations and deal-breakers early in the process. The opportunities for this leasing market are exciting if both the landlord and tenant sides are willing to bend and work together to create a lease that may break the mold.

Authors

Jennifer J. Understahl

Partner
JUnderstahl@perkinscoie.com 602.351.8090