

How Landlords Should Collaborate with High Tech Tenants During Lease Negotiations to Maximize Mutual Benefits with Acceptable Risks

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I. Introduction.

Leasing to tech tenants is on the rise, especially in the tech hubs such as Manhattan, Santa Monica, Silicon Valley, San Francisco, Seattle, and Bellevue.

This sudden influx of technology oriented tenants leasing office space has led to a host of new issues to focus on during lease negotiations, to meet tenant demands but, at the same time, maintain rental streams and protect building value (for sale and financing).

In particular, technology tenants are highly focused on maximizing non-traditional space utilization and allowing for high levels of density, 24/7 within their premises, controlling common area utilization, including creating green space, alternative commuter opportunities, and non-traditional uses.

In addition to these new issues, leasing to technology tenants requires landlords to re-think typical landlord positions on traditional lease issues, such as credit enhancements, competitor protection, surrender and restoration obligations, and tenant involvement in design and construction of base building and common areas.

Lastly, landlords now need to focus upon certain non-real estate oriented issues that have not previously been addressed in lease documentation.¹

II. Types of Tech Tenants.

Not all technology tenants are created equal, and these tenants can generally be sorted into three categories of descending business maturity and financial strength.

The first category of technology tenants ("**Mature Tenants**") are tenants with a history of steady revenue and profits, and broad name recognition (e.g., Google, Apple, Microsoft, Facebook, and Netflix). Lease negotiations with Mature Tenants tend to be reflective of an employee and work-environment centered approach.

¹ Sample clauses addressing some of the issues discussed in this paper are included in Schedule 3.

The second category of tenants ("**IPO Tenants**") tend to be established entities that are either gearing up for an initial public offering or have recently completed an initial public offering, but have uncertain futures and little earnings history. Lease negotiations with IPO Tenants tend to be reflective of their financial-centric leadership, and have a more functionally conservative approach than Start-Up Tenants.

The last category pertains to tenants in their earliest stages of development ("**Start-Up Tenants**"). Lease negotiations and the specialization of Start-Up Tenants is generally reflective of their entrepreneurial-style leadership.

III. **New Issues in Leasing to Tech Tenants.**

All types of technology tenants are different than more typical office tenants and are interested in utilizing office space in new and different ways. . Because of these new issues, many tech tenants are highly interested in leasing ground-up development space, and, therefore, the analysis below also includes recommendations relating specifically to new developments.

1. **Non-Traditional Uses.** Tech tenants are interested in using office space for other than traditional office uses, such as allowing pets, fitness centers, wellness centers, extensive food services, and on-site childcare. Rather than prohibiting, or staying silent on these uses, lease documents should include detailed restrictions and requirements.

Provisions in leases allowing pets to be brought into the premises, should (1) specifically limit the number, type, and size of the pets, (2) specify the path of travel for the pets to enter the premises, such as prohibiting any pets in the ground floor lobby and only allow use of the freight elevator, and (3) the ability to ban specific pets for displaying aggressive behavior or for an pet-owner's failure to comply with project rules. Note, however, that some of these requirements, such as path of travel, can be relaxed for a campus-style project, as opposed to a high-rise multi-tenant environment. Attached hereto as Schedule 1 is an example of a dog clause for use in lease transactions. This clause contains the foregoing attributes in addition to other landlord protections.

Provisions in leases allowing fitness centers, wellness centers, cafeterias, and child care, should (1) prohibit use of these services by the public, and if applicable, other tenants of the project, (2) include requirements for third-party providers (e.g., insurance, licensing, indemnification obligations), (3) specify removal obligations and landlord engineering involvement in initial construction, and (4) mandate compliance with applicable laws, licensing, and health and safety codes.

2. Alternative Commuter Opportunities. Particularly for ground-up developments, tech tenants are drawn to projects that allow for alternative commuter opportunities. This is frequently limited by the location of the project, but owners will need to consider offering shuttle services, and/or subsidizing public transportation. All owners should anticipate installation of traditional bicycle racks, as well as the need for secured bicycle storage lockers and shower facilities. On a project-by-project basis, owners should also consider sensitivity to allowing bicycles to be brought into tenants' premises, taking into consideration the path of travel, effect on elevator usage, and likely damage to common areas.

3. Control of Common Areas. When leasing space, many tech tenants also look for the availability, and exclusivity, of amenity space in common areas, such as roof decks and terraces. While exclusivity is highly deal specific, at a minimum, owners should always retain use rights for landlord-hosted events, or to show off the space to potential partners, purchasers, and financing sources. In addition, owners should maintain approval rights over all personal property that the tenant can install in these areas, and dictate minimal quality standards for improvements.

4. High Density and 24/7 Occupancy. Tech tenants value high density space which can be used on a 24/7 basis, which means that owners need to design (for ground-up developments) or upgrade (for existing buildings) the building systems that accommodate these high density and high traffic uses, such as HVAC systems, elevator speeds, width of fire stairs, and number of restrooms. Some owners attempt to address density related issues by including a specified density limitation in lease documents (e.g., tenant's use shall not result in a density in excess of one person per each 300 square feet of the premises). The much better approach is to only cite code requirements for density, and make clear the specifications and requirements that the building has been designed to accommodate. For example, the lease should be clear that the HVAC functioning temperature range, and useful life of the HVAC equipment, is only designed to accommodate a specified density during specified operating hours. The lease should then allow the landlord to require the tenant to install supplemental HVAC units to maintain comfortable temperatures in the premises, and to charge the tenant directly for increased wear and tear on building systems relating to excess usage.

IV New Focuses on Traditional Issues.

In many ways, technology tenants are different than more typical office tenants, and, therefore, many traditional leasing issues take on a new light in tech tenant leasing.

1. Competitor Protection. Competitor protection for technology tenants typically includes restrictions on leasing space at the project to competitors and on granting signage or advertising

rights to competitors. Many tech tenants cite concerns over poaching of employees by competitors as the reason for leasing restrictions. Given use of the internet and social media to recruit new talent (as opposed to physical proximity), the actual merit of the argument seems to be waning, but it is unlikely that a landlord will be able to avoid granting any competitor protection due to tenant sensitivity. Lease provisions granting competitor protection should (1) specify a finite list of competitors, (2) exclude affiliate entities, (3) pertain only to competitors that compete with the business that the tenant is operating from the premises (e.g., a lease with Samsung's cellphone division would have different competitors than a lease with Samsung's television division), (3) include the ability for the tenant to change the list, no more than once a year, during a specified window, to avoid reactions to market information, (4) should be personal to the original tenant under the lease and require the satisfaction of a minimum leasing and occupancy requirement, and (5) not apply to corporate mergers and acquisition activity of an existing tenant or subleasing or assignments by an existing tenant.

2. Credit Enhancements. For Start-Up Tenants and IPO Tenants, credit enhancement is a key aspect of any deal. Almost all credit enhancement takes the form of a letter of credit.

Given the magnitude of the letters of credit that tech tenants provide, rather than including bank credit rating requirements, owners should instead require that the letter of credit issuer be one of a short-list of specified banks (e.g., JP Morgan Chase, Wells Fargo, or Bank of America). Owners should take care to not accept a letter of credit from the internet banking division of these specified banks, and insist on the main, publically traded entity.

The primary concern when determining credit enhancement for leases with technology tenants is the risk of a tenant bankruptcy. Bankruptcy may create delays or stall a landlord's ability to utilize credit enhancements due to a bankruptcy court enjoining Landlord's use of the credit enhancement. In addition, Section 502(b)(6) of the Bankruptcy Code artificially caps the landlord's damages due to a rejection (or deemed rejection) of the lease at the "rent reserved by such lease," without acceleration, for the greater of (i) one year, or (ii) fifteen percent, not to exceed three years, of the remaining term of such lease. This cap also applies to other damages that the landlord may suffer due to the tenant's termination of the lease, such as restoration or other surrender obligations.

There is some debate as to what constitutes "rent reserved" for purposes of calculating the cap under Section 502(b)(6), but presumably, the term "rent reserved" in the context of a triple-net or base year lease would include, at a minimum, base rent, parking charges, taxes and insurance. It is debatable whether "rent reserved" includes other common area maintenance costs.

As set forth above, the letter of credit is the most common type of credit enhancement used in technology tenant leases because of the ability to minimize a landlord's bankruptcy risk, specifically as relates to (i) preventing the bankruptcy court from enjoining disbursement of letter of credit proceeds to tenant, and (ii) potentially allowing a landlord to avoid the cap on "rent reserved".

Since the letter of credit creates an independent contract between the issuing bank and the landlord, as beneficiary of the letter of credit, once the landlord makes a demand in compliance with the terms of a letter of credit, the tenant may not prevent the issuing bank from distributing the proceeds of the letter of credit, absent fraud in the underlying contract. Bankruptcy courts have recognized this "independence principal" in finding that the proceeds of a letter of credit are not property of the tenant's bankruptcy estate and that a bankruptcy court has no authority to enjoin the payment under a letter of credit.

In addition, given that the issuing bank's obligation under a letter of credit is independent from the landlord tenant relationship, arguably neither the bank nor the debtor can assert the cap to estop a landlord from collecting the full amount of its damages from the issuing bank. Although there is no bankruptcy court authority that has addressed this issue, case law in analogous situations seemingly supports this conclusion. In the event the amount of the letter of credit is less than the bankruptcy cap, then there is no issue.

There are many factors that are used in the market to determine the amount of the letter of credit in each lease transaction. The main factors for determining the amount of the letter of credit are the type of tech tenant (as described in Section II, above) involved and the amount of concessions involved in the lease transaction. At the time this paper was written market conditions usually result in letters of credit within the following ranges. The exact amount within the range is determined by reviewing the financial statements of a specific tenant, the size of the transaction and concessions involved, as well as the factors described below.

Start-Up Tenants	A letter of credit equal to between 12 and 18 months of base rent.
IPO Tenants	A letter of credit equal to between 7 and 8 months of base rent, but sometimes as low as 3 to 4 months of base rent, and sometimes as high as between 9 and 10 months of base rent.
Mature Tenants	No letter of credit or other enhancement required.

The general framework and range for letter of credit amounts set forth above is fairly accurate- see Schedule 2 for more detail. Note the largest range for letter of credit amounts is for IPO Tenants (including a few outliers outside of the specified range) because determining the amount of the letter of credit for an IPO Tenant is highly dependent upon a number of factors that can distinguish tenants within this category, such as how close the tenant is to an IPO (or how recently the tenant completed the IPO, and the tenant's market capitalization following the IPO), the tenant's profit history, and the length of time the tenant has been in business.

There are other factors to consider when determining the amount of a letter of credit. Many leases with technology tenants pertain to buildings that are still under construction at the time that the lease is signed. This type of development deal creates more risk to a landlord than a shorter time line deal because of the time that lapses between signing the lease and the landlord receiving its first rent check. This is particularly risky for tenants with uncertain financial futures at the time the lease is signed (i.e., Start-Up Tenants and IPO Tenants), and therefore, amounts of credit enhancement are usually at the higher end of the range for each category of tenant.

Technology tenants are infamous for spending a large amount of money on constructing their premises. These build-outs frequently include unusual items that are expensive to restore (e.g., aquariums, swimming pools, basketball courts, shower facilities, roof decks, sky bridges, and excessive numbers of electrical vehicle charging stations and bicycle racks). Therefore, the calculation of the amount of the letter of credit might also consider the amount of funds necessary for a landlord to fulfill any tenant surrender obligations, whether or not the lease is terminated.

Similarly, it is common for a landlord to grant a technology tenant an above-standard tenant improvement allowance. It is important to focus on the possibility of the landlord being able to recover a significant amount of the tenant improvement allowance in the event of a lease termination and to minimize the risk of a default by the tenant before the lease commences resulting in an incomplete build-out with the possibility of a large number of mechanic liens. In addition to a letter of credit, a landlord can also minimize the risk of incomplete construction by requiring the tenant to provide upfront cash prior to the commencement of construction in an amount equal to the total cost of the construction, less the total tenant improvement allowance.

The lease should also include a mechanism to increase the amount of the letter of credit (on a proportionate basis, or otherwise) in the event a tenant has rights to expand the project by way of must-take rights, rights of first refusal, rights of first offer, or other expansion options.

Frequently, in non-technology tenant deals, credit enhancement is seen by landlords and tenants as a mechanism to allow a landlord to recover the upfront costs spent by the landlord in

connection with the lease in the event the lease is terminated prior to the landlord recouping these costs through the rental stream. In these situations, therefore, it is also common that the initial letter of credit amount will be based on the total tenant improvement allowance, free/abated rent, and brokerage commissions, and that the amount will automatically burn down at set intervals during the lease term as these up-front costs are amortized through the rent stream.

For leases with technology tenants, however, the credit amount is calculated in terms of months of base rent and the main purpose of the credit enhancement is to incentivize the landlord to enter into the lease with the tenant, notwithstanding the financial condition of the technology tenant involved. Therefore, letters of credit for technology tenants usually are reduced only if a tenant is able to satisfy certain financial parameters, and do not always automatically reduce due to the passage of time as is the case with credit amounts calculated based on the amount of the concession package. For example, a reduction could be tied to (1) the tenant maintaining a positive net operating cash flow for set number of quarters, together with satisfying a minimum tangible net worth requirement, or (2) an initial public offering with a minimum equity market capitalization. The exact financial parameters should be determined after a review of the tenant's financials, and following a discussion with the tenant about their near-term and long-term anticipated growth and IPO goals.

In any event, the letter of credit should never be reduced below an amount necessary to allow the landlord to perform the Tenant's surrender and restoration obligations, as set forth below.

3. Surrender and Restoration. Because of the unusual uses described above, all leases should include surrender and restoration obligations for non-general office installations. At a minimum, as mentioned above, the amount of the letter of credit remaining at the end of the lease term should include sufficient funds to satisfy these removal and restoration obligations.

4. Tenant Involvement in Design and Construction of Project. In ground-up developments, Start-Up Tenants and IPO Tenants seek input on the design aesthetics and the functionality of building systems. The parameters and timing of this input should minimize effects on the building quality and construction timelines. Mature Tenants, on the other hand, usually prefer that an owner not build certain components of a project, and instead take on these obligations themselves (with broader control rights).

V. **Non-Lease Issues.** Leases with technology tenants also frequently involved negotiating provisions that were traditionally outside of the landlord-tenant relationship.

1. **Intellectual Property Rights.**

Many technology tenants are highly sensitive to intellectual property issues. Specifically tenants want to limit usage of their name and logo to maintain trademark protection. In no event should the tenant's intellectual property concerns prevent the landlord from operating in the ordinary course of business, such as including the use of the tenant's name in marketing materials and offering materials, disclosing lease and tenant information in annual financial reports, and maintaining an up-to-date and detailed project website.

2. **Financial Accounting.** In ground up developments, IPO Tenants typically require review and approval of the lease document by their accounting team. The accounting team's goal is to avoid including the building as a capital asset, as opposed to a lease liability in the tenant's books. This determination is made by a review of several factors, including the liability of the tenant during the construction period, the ability for the tenant to participate in the design of the building, and the ability of tenant funds to be used to construct the building. Unfortunately, each accounting team has different interpretations of the applicable accounting rules, and therefore each deal will require negotiating and developing unique solutions to accountant-created problems. At a minimum, the lease will include language limiting the liability of the tenant during the construction period, for both actions of the tenant and rent obligations, to 89.5% of the landlord's total project costs (excluding land costs). This is an acceptable limitation because the landlord's project costs are typically going to be much higher than any liability or rent due during the construction of the building. The bottom line for landlords is that accommodating the tenant's accounting team should never result in any increased liability or risk.

Schedule 1

DOGS

1. Tenant's Dogs.

1.1. **In General.** Tenant shall be permitted to bring up to a total of ten (10) non-aggressive, fully domesticated fully-vaccinated, dogs, none of which weigh more than thirty (30) pounds, into the Premises (which dogs are owned by Tenant or an officer or employee of Tenant) ("**Tenant's Dogs**"). Tenant's Dogs shall not include service animals (as defined under applicable Laws and accompanying guidelines) and this Section 1 shall not be applicable to such service animals, provided that the number of Tenant's Dogs allowed shall be reduced by each service animal already present in the Premises (i.e., if there are five (5) service animals in the Premises, only five (5) additional Tenant's Dogs shall be allowed). Tenant's Dogs must be on a leash while in any area of the Project outside of the Premises. Tenant's Dogs shall at no time be allowed on the rooftop deck of the Building. Within three (3) business days following Tenant's receipt of Landlord's request, Tenant shall provide Landlord with reasonable satisfactory evidence showing that all current vaccinations have been received by Tenant's Dogs. Tenant's Dogs shall not be brought to the Project if such dog has fleas or ticks, is ill or contracts a disease that could potentially threaten the health or wellbeing of any other dog, or any tenant or occupant of the Building (which diseases may include, but shall not be limited to, rabies, leptospirosis and lyme disease). While in the Building, Tenant's Dogs must be taken directly to/from the Premises and Tenant shall use the Building freight elevator, or other elevator designated by Landlord, to bring Tenant's Dogs to/from the Premises. Tenant's Dogs may only be brought into the Premises using the access route set forth on **Exhibit A** attached hereto, or such other reasonable access route as may be designated by Landlord. Tenant shall not permit any objectionable dog related odors to emanate from the Premises, and in no event shall Tenant's Dogs be at the Project overnight. Tenant's Dogs shall not be permitted to defecate or urinate at the Premises or Project, and shall be removed from the Building at regular times to allow defecation or urination at places other than the Project. Any bodily waste generated by Tenant's Dogs in or about the Project shall be promptly removed and disposed of in trash receptacles designated by Landlord, and any areas of the Project affected by such waste shall be cleaned and otherwise sanitized. No Tenant's Dog shall be permitted to enter the Project if such Tenant's Dog previously exhibited dangerously aggressive behavior, as determined by Landlord in Landlord's sole discretion. Notwithstanding the foregoing, Landlord shall have the right, at any time, to prevent particular dogs from entering or accessing the Premises if dogs are in violation of the terms of this Section 1, have previously been in violation of one or more of the terms of this Section 1 or Landlord has received a complaint from any tenant regarding damage, disruption or nuisance caused by a dog in the Building or the Project, which complaint is, in Landlord's reasonable business judgment, legitimate and not intended solely to harass or frustrate Tenant's use and occupancy of the Premises or Tenant's right to bring Tenant's Dogs into the Premises in accordance with this Section 1. The indemnification provisions of this Lease shall apply to any claims relating to any of Tenant's Dogs

1.2. **Costs and Expenses.** Tenant shall pay to Landlord, within ten (10) business days after demand, all costs incurred by Landlord in connection with the presence of

Tenant's Dogs in the Building, Premises or Project, including, but not limited to, janitorial, waste disposal, landscaping, signage, repair, legal costs and expenses, and costs of issuing "Dog Tags" as defined in Section 1.3, below. In the event Landlord receives any verbal or written complaints from any other tenant or occupant of the Project in connection with health-related issues (e.g., allergies) related to the presence of Tenant's Dogs in the Premises, the Building or the Project, Landlord and Tenant shall promptly meet and mutually confer, in good faith, to determine appropriate mitigation measures to eliminate the causes of such complaints (which mitigation measures may include, without limitation, additional and/or different air filters to be installed in the Premises HVAC system, or elsewhere in the Building), and Tenant shall cause such measures to be taken promptly at its sole cost or expense.

1.3. **Registration.** Each of Tenant's employees that desires to bring a dog to the Premises as one of the Tenant's Dogs (each, a "**Dog Owner**") shall be required to provide reasonable evidence to Landlord that such dog meets the requirements of Section 1.1, above. Such Dog Owner shall additionally be required to execute an agreement (the "**Dog Agreement**") assuming full responsibility for any damages or claims resulting from the presence of Dog Owner's dog at the Project, and indemnifying Landlord for any such damages or claims as provided in the Dog Agreement. At Landlord's option, each of Tenant's Dogs shall be issued an identification tag or card, which may include a photo (the "**Dog Tag**"). Landlord may require that if a Dog Owner does not have the applicable Dog Tag in his or her possession, Landlord may refuse to allow such dog to enter the Project. At Tenant's request, Landlord may require that each Dog Owner pay Landlord directly for issuance of a Dog Tag. At any time and from time to time Landlord may require a Dog Owner to provide reasonable evidence that the applicable dog continues to meet the requirements of Section 1.1, above.

1.4. **Rights Personal to Original Tenant.** The right to bring Tenant's Dogs into the Premises pursuant to this Section 1 is personal to the Original Tenant and its Permitted Transferees. If Tenant assigns the Lease or sublets all or any portion of the Premises, then, as to the entire Premises, upon such assignment, or, as to the portion of the Premises sublet, upon such subletting and until the expiration of such sublease, the right to bring Tenant's Dogs into such portion the Premises shall simultaneously terminate and be of no further force or effect.

1.5. **Termination of Rights.** In the event that the terms of this Section 1 are breached on more than three (3) occasions in any twelve (12) month period, Landlord shall have the right to revoke Tenant's right to bring Tenant's Dogs into the Premises, in which event the terms of this Section 1 will be of no further force or effect.

Schedule 2

Start-Up Tenants

Building Address	Approx. Size of Premises	Approx. Securitization
Redwood City	350,000 sf	17 months of base rent
San Francisco	121,000 sf	10.3 months of base rent
San Francisco	13,000 sf	9 months of base rent
San Francisco	53,000 sf	20 months of base rent
San Francisco	91,000 sf	14.7 months of base rent

IPO Tenants

Building Address	Approx. Size of Premises	Approx. Securitization
San Francisco	17,700 sf	4 months of base rent
San Francisco	21,000 sf	7.4 months of base rent
San Francisco	83,000 sf	12.5 months of base rent
San Francisco	110,000 sf of expansion space	19.2 months of base rent
San Francisco	170,000 sf	13 months of base rent
San Francisco	130,000 sf	13 months of base rent
San Francisco	450,000 sf	5.8 months of base rent
Sunnyvale	587,000 sf	5.23 months of base rent
San Francisco	235,000 sf	5.8 months of base rent
San Francisco	410,000 sf	6 months of base rent
San Francisco	750,000 sf	8 months of base rent
San Francisco	450,000 sf	7 months of base rent

San Francisco	Initial: 182,000 sf Must-Take: 61,000 sf	12 months of base rent, following Must-Take Commencement.
San Francisco	80,000 sf	13.6 months of base rent
San Francisco	88,000 sf	20.8 months of base rent

Mature Tenants

Building Address	Approx. Size of Premises	Approx. Securitization
San Francisco	270,000	None
Sunnyvale	1,900,000 sf	None
San Francisco	50,000 sf	None