

What's the Big Deal?!

Issues in Negotiating Large Office Leases

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In the case of smaller office leases, it is not practical for tenants to attempt to address every significant issue and risk found in a landlord's lease form. Although a landlord's office lease form is often very one-sided, a simple cost-benefit analysis will dictate that a smaller tenant should not spend a year's worth of rent on attorney's fees trying to negotiate the lease. Instead, tenants in smaller office leases are often left to rely on protections outside of the lease, such as the reputation and good faith of the landlord, market forces and incentives that regulate the behavior of landlords, and, in some cases, blind faith.

In larger office lease transactions, however, the financial and other risks to both landlords and tenants are much greater. Consequently, the parties are willing to leave fewer things to chance. Large office leases allow landlords to fill large blocks of vacant space at one time and can have a significant effect on the value, marketability, and financeability of an office project. For tenants, a large office lease is not just a routine real estate deal; it is often a long-term commitment with a major effect on the tenant's operations and financial condition.

For those reasons, the negotiations between landlords and tenants become much more involved, in terms of both time and complexity. Typical lease issues tend to get negotiated much more heavily, and other issues arise that are not typically encountered (or, for practical reasons, addressed) in smaller lease deals. To get to a final lease, it will likely take a village—of brokers, attorneys, design professionals, moving and IT consultants, insurance and risk management advisors, contractors, and project managers—all of whom need to be managed and coordinated throughout the process.

This article summarizes some of the issues unique to, or at least magnified in, large office lease deals. Every deal is different, of course, and some large office deals will be much more difficult than others. As always, the relative leverage and bargaining positions of the parties will be the single biggest driver of what a tenant can demand, and what concessions a landlord will make, during lease negotiations. One would expect that a credit tenant leasing a significant amount of space would enjoy significant leverage, and this is often the case. In markets where large blocks of quality office space are scarce and construction costs are high, however, the scales can often tip back in the landlord's favor.

Construction Issues

One of the most significant differences between large and small office deals is the size, complexity, and cost of the tenant's build-out. Large office leases typically involve a significant, complicated, and very expensive build-out of the new space to suit the tenant's specific needs. As a result, the construction work letter becomes a critical and heavily negotiated part of the lease, containing detailed provisions regarding allocation of responsibilities to perform and pay for portions of the work (for example, base building work vs. tenant improvement work), approval of plans and specifications, construction budgets, tenant improvement allowances, bidding and selection of design professionals and contractors, and the effect of landlord and tenant delays.

The timing for completion of the build-out is often critical for the tenant, given the logistics of moving and relocating employees, as well as the potential for significant holdover penalties at the tenant's current location. As a result, a tenant often will try to negotiate for significant penalties for a landlord's delay in delivering the space. The types of penalties (or, from the tenant's perspective, "incentives") that a tenant might request include rent credits or liquidated daily delay damages, self-help rights, and, ultimately, termination rights (possibly including reimbursement for some or all of tenant's out-of-pocket transaction costs).

Obviously, landlords will attempt to avoid these types of penalties or at least try to limit the landlord's risk by building in as much flexibility and cushion as possible, particularly for delays caused by the tenant or by factors outside of the landlord's reasonable control. Landlords are also well advised to avoid open-ended exposure for the tenant's holdover costs, lost opportunity costs, and other similar types of damages.

The logistics of moving a tenant's employees, furniture, fixtures, and equipment on such a large scale can be very complex, including coordination of a number of different vendors and contractors. The parties will need to address issues such as the tenant's ability to use the building's loading docks and freight elevators, as well as the extent to which the tenant will be responsible for the costs of any utilities used during construction. Landlords also need to consider and address the potential effect and disruption that can be caused by a large tenant's moving and construction activities.

Beyond the initial construction of the space, a large office tenant will want flexibility during the lease term to modify its premises to accommodate its changing space needs. As a result, the tenant may demand greater latitude to perform certain types of alterations without the landlord's consent. The tenant may also seek to avoid any end-of-term responsibilities to remove alterations or improvements (including even specialized alterations like internal staircases and private restrooms) or any of the tenant's wiring and cabling. If a tenant is successful in avoiding these potentially significant removal costs (costs that a landlord may or may not be able to pass on to a subsequent tenant), the landlord will need to factor them into the economics of the deal.

Security Issues

Because large office leases typically involve such large and expensive build-outs, these leases also often include very significant tenant improvement and other allowances (such as allowances for design costs; furniture, fixtures, and equipment costs; wiring and cabling costs; and costs to renovate lobbies, restrooms, and other common areas). In addition, large office tenants often will seek other significant cash incentives, including relocation allowances and a payment or subsidy for the tenant's current lease obligations.

To justify their significant up-front, out-of-pocket costs in a large office deal, a landlord should undertake a comprehensive underwriting process to evaluate the tenant's creditworthiness. As part of this process, the landlord needs to consider what type of security it may require from the tenant, such as cash security deposits, letters of credit, and third-party guaranties. If the costs of the tenant improvement work exceed the amount of the improvement allowance being provided by the landlord, the landlord also may seek to secure (through escrow, a letter of credit, or otherwise) the tenant's obligation to pay construction costs in excess of the allowance. Also, if the tenant is performing some or all of its own tenant improvement work, a landlord may require the tenant to obtain payment and performance bonds covering the work.

Landlords are not the only parties, however, with significant underwriting and credit risk in these larger deals. Because these large office leases involve such significant allowances and construction obligations, tenants need to be very concerned about a landlord's ability to pay the allowances and perform its obligations. As a result, and particularly over the last five years or so, tenants have become increasingly more focused on due diligence regarding not only the financial condition of the landlord entity but also the debt structure of the office project (for example, how much, if any, equity is there in the project, and when does the debt mature?).

To secure the landlord's payment and other obligations, tenants may ask for some of the same types of security requested by landlords, including escrows, letters of credit, and third-party guaranties. Also, given the bankruptcy risks associated with certain types of security (for example, escrow accounts, cash, and even letters of credits), a tenant might seek some sort of self-help or set-off rights for a landlord's failure to fund the allowance or otherwise perform its construction obligations.

Operating Expenses and Audit Rights

Relative to smaller tenants, the tenant in a large office deal is obviously paying a much higher proportionate share of the operating expenses of the office project. Over the life of a long-term lease, the operating expense amounts paid by a large office tenant can be staggering, and, as might be expected, the operating expense provisions of the lease will get a lot of attention during negotiations. The tenant will closely scrutinize and negotiate the definition of "operating expenses" in the landlord's lease form and seek to eliminate noncustomary expenses, as well as any landlord profit centers. Likewise, the list of operating expense exclusions is likely to become mind-numbingly long and comprehensive.

Given the number and nature of the limitations and exclusions negotiated by large tenants, the landlord's property management and accounting teams will often be heavily involved in the lease negotiation process on these issues. Larger tenants will attempt to negotiate for caps on operating expenses, which may include the more common annual controllable operating expense caps, as well as hard caps on operating expenses during the first year or over some longer period. Given the dollar amounts involved in larger leases, audit rights are also much more important, and tenants will try to negotiate for broader and more flexible audit rights over a longer period of time, often with a detailed dispute resolution process.

Tenant Flexibility

In a large office lease deal, the tenant often seeks significant flexibility in terms of both growth and exit strategies.

Expansion Rights

Because a large office tenant is likely to make a significant, long-term commitment to a building, the tenant will be looking to secure expansion rights allowing for future growth. One form this commitment might take is a straight expansion right, which would allow the tenant to lease any vacant space (anywhere in the building or on specified floors), either on the tenant's then-current lease terms or on market terms.

In lieu of, or often in addition to, these expansion rights, tenants may be looking for other "first" rights for expansion space. For example, a tenant might want a right of first offer, giving the tenant the opportunity to lease vacant space before the landlord goes to market with the space. As with straight expansion rights, these rights of first offer are typically on market terms, although a landlord may agree to allow the tenant to take the additional space on its then-current lease terms, at least for some period of time after the initial lease commencement. The tenant also may want a right of first refusal to match any third-party offer for the expansion space.

Landlords should be very careful when granting these types of expansion rights (and especially multiple layers of expansion rights to multiple tenants), because they can create significant roadblocks to a landlord's efforts to market and lease up vacant space. Also, to avoid granting conflicting or inconsistent rights, landlords need to be acutely aware of what rights have been granted to which tenants. Similarly, because of the importance and value of these expansion rights, larger tenants will pay particular attention to the renewal and expansion rights that the landlord has granted to other building tenants, as well as the relative priority of its rights in comparison to the rights of existing and future building tenants.

Early Termination and Contraction Rights

Often, larger tenants are looking not only for flexibility to expand in the event of future growth, but also for flexibility in terms of downsizing and early exit strategies. For example, a significant tenant may want the right to terminate the entire lease on one or more fixed early termination dates, or even on a rolling basis (maybe after some minimum number of years), in each case with sufficient advance notice to the landlord.

Large tenants also may seek contraction rights that allow the tenant to give back blocks of space to the landlord, also at fixed times or on a rolling basis. These types of early termination or contraction rights typically involve the payment by the tenant of an early termination fee, which may include some number of months' rent, plus repayment of landlord's unamortized leasing costs (for example, broker commissions, free rent and other concessions, tenant improvement costs, and legal fees) for the space being terminated.

Renewal Rights

In smaller office leases containing an option to renew, tenants rarely renew their leases in strict accordance with the renewal option language. As a result, smaller tenants often view these renewal options as a worst-case scenario backstop and elect not to heavily negotiate the renewal option language. In large office leases, however, the renewal options can be of critical importance and tend to be heavily negotiated, as the odds of a dispute over a renewal rent rate—and the risks associated with a renewal rate dispute resolution process—are much greater than they are with a smaller lease.

The parties need to pay special attention to the mechanics of how and when renewal exercise notices must be given and the definition and the determination of the "fair market rent" rate to be paid during renewal terms, including any third-party dispute resolution process that would apply if the landlord and tenant fail to agree on the fair market rent rate. Some tenants will request the right to rescind their renewal exercise *after* seeing the results of the dispute resolution process. Many landlords will reject such a proposal, arguing that giving the tenant (but not the landlord) multiple chances to bail out during the process gives the tenant undue leverage by virtually eliminating any chance that the process will lead to anything but a very tenant-friendly outcome.

Also, to avoid an unintentional waiver by the tenant of critical renewal rights, the tenant often will seek to include a nonforfeiture clause providing that, if the tenant misses its renewal exercise deadline, the renewal option is not waived unless and until the tenant receives written notice and an additional short window in which to exercise its option has expired. Another issue that may arise is whether the tenant should have the right to exercise the renewal option for some, but not all, of the premises. Landlords may agree to such a request, although they will want to specify that the renewal can be exercised only for some minimum block or configuration of space (for example, full floors).

Assignment and Subletting Rights

Larger tenants will seek flexibility in assignment and subletting rights. Some large tenants will push for the unrestricted ability to assign or sublease without the landlord's consent, although landlords generally resist unfettered transfer rights. As with smaller leases, landlords generally will agree to allow a larger tenant to assign or sublease to affiliates and successors following merger and acquisition transactions without the landlord's consent, possibly subject to the transferee meeting a tangible net worth or other financial condition test.

A big tenant also may require the flexibility to sublease portions of the premises in the event that it has extra space it wants to “space bank” for the future. This is generally acceptable to landlords, although the landlord may look to cap the amount of space (often as a percentage of the entire premises) that the tenant can sublease without consent.

One issue that arises is whether the landlord will be required to provide subtenants with nondisturbance or recognition agreements assuring the subtenants of their rights to stay following an early termination of the prime lease. Although this right may be important to many potential subtenants, there are risks to the landlord associated with providing nondisturbance agreements. For example, if the landlord terminated the prime lease as a result of a default, the last thing the landlord would want is a small subtenant camped out in the middle of an otherwise vacant full floor. Therefore, a landlord may want to condition any obligation to provide a subtenant with a nondisturbance agreement on the subtenant’s taking a minimum amount of space (for example, a full floor) and meeting certain underwriting criteria.

Larger tenants may attempt to significantly limit or even eliminate a landlord’s recapture rights, as well as the landlord’s right to share in any profits in connection with any transfers by the tenant. Although an assigning tenant typically would remain liable for the tenant’s lease obligations following an assignment, significant tenants frequently will seek release rights in the event of an assignment to a transferee meeting certain criteria (for example, an assignment to another credit tenant). Many landlords will agree to these types of release provisions, subject to negotiating a sufficiently high credit-worthiness standard for qualified assignees.

Holdover

As discussed above, the timing and logistics of building out space for a large office tenant and relocating the tenant can be difficult, and, as a result, delays are more likely to occur. These delays increase the chance that a large tenant’s new location will not be ready by the time the tenant’s current lease expires, exposing the tenant to the risk of a very costly holdover situation in its current location.

Most landlord lease forms provide that a holdover tenant will be liable for from 125% to 200% of the rent during any holdover period, as well as for any damages (including consequential damages) that its new landlord may suffer as a result of the tenant’s holdover, such as the loss of a prospective tenant or penalties payable to a succeeding tenant. As discussed above, a new tenant may attempt to pass some of this risk on to its new landlord in the form of delay damages.

When negotiating a lease, there are several ways the large office tenant may try to reduce its holdover risk at the end of its lease term. The tenant may request some sort of short-term holdover (that is, extension) right that would allow the tenant to extend the term for some short period of time (often 90 to 180 days) on some minimum amount of written notice before the end of the term. The short-term holdover could be at the then-current rental rates or at some increased rate (still typically lower than the holdover penalty rate).

One issue that the parties face is whether a holdover in a portion of the premises should constitute a holdover in the entire premises. Similar to the early termination and contraction rights discussed above, a landlord may agree that the tenant's holdover should be determined on a floor-by-floor basis, which would allow a tenant to hold over on one or more full floors while surrendering (and avoiding any holdover consequences for) other full floors.

The large office tenant will want to reduce the holdover rental rate, and it is common for landlords and tenants to agree on a fixed rate (for example, 125% to 150%) or graduated holdover rates based on the length of the holdover (for example, 125% for the first 30 to 60 days and 150% to 200% thereafter). A big concern for landlords is the ability to deliver the space to a succeeding tenant, so landlords typically will fight to keep some exposure on the expiring tenant for failing to timely vacate the space. Similar to graduated holdover rates, however, landlords and tenants often will negotiate for some short period of time (often 30 to 90 days) during which the tenant will not be exposed to consequential damages and the landlord's sole remedies for holdover would be the increased holdover rental rate and the right to seek repossession of the space.

Casualty

In smaller office leases, the casualty provisions in a lease are not often negotiated heavily. While the casualty terms of a typical landlord's lease form are heavily weighted in the landlord's favor, given the relatively low risk of a fire or casualty, the costs of negotiating these provisions typically outweigh the benefits of doing so. Another factor reducing the risks for smaller tenants is that the tenant is likely to have more potential options for replacement space if a lease is terminated following a fire or casualty event. The opposite is often true in the case of a large office lease because large, contiguous blocks of quality office space are often very difficult to find.

A large office tenant also may have negotiated for a significant number of beneficial rights and have a rent structure that is favorable and potentially below market, making the tenant's leasehold interest very valuable, so the large office tenant will want to minimize the risk that the lease can be terminated after a fire or casualty event, particularly under circumstances that might allow a landlord to use a fire or casualty event as a pretext for terminating or renegotiating a below-market lease. Large office tenants, therefore, often will try to significantly limit the circumstances under which a landlord can terminate in the event of a fire or casualty.

Landlord lease forms often limit a landlord's restoration obligation to the amount of available insurance proceeds. To minimize the risks of such a provision, the tenant will want to ensure that the lease requires the landlord to carry adequate property insurance, and the tenant may try to negotiate for some amount of insurance shortfall—similar to a deductible—that the landlord would be required to fund out-of-pocket. To further reduce the risk that a landlord might seek to cherry-pick a below-market lease for termination, the tenant might require that, in order to terminate the tenant's lease, the landlord also would be required to terminate other leases in the building as a result of the damage. In some cases, the tenant might even try to impose on the landlord some sort of negative covenant preventing the landlord from terminating the tenant's lease and then rebuilding a similar office project on

the site. For obvious reasons, these sorts of limitations and concessions can be very complicated and problematic for landlords (and their lenders), so these issues require a great deal of thought and negotiation.

Other Special Tenant Rights

This section lists a few of the other rights that may be available to a tenant taking a large block of space but that generally would not be available to smaller tenants. For some of the other rights described in this article, landlords will frequently seek to condition them on the tenant's continuing to lease and occupy some minimum amount of space in the building. The parties likely will end up negotiating the extent to which these rights would be transferable to the tenant's successors by way of assignment or sublease.

Building Signage and Naming Rights

A very significant building tenant may look for the right to exterior signage on the building or the right to name the building. Large tenants also may seek to restrict the right of the landlord to grant exterior building signage rights or naming rights to the tenant's competitors or other large tenants in the building.

Services

A large office lease often will include detailed—and sometimes heavily negotiated—standards and specifications defining the landlord's obligations to provide building services such as HVAC, janitorial, elevator, and recycling/sustainability programs. The tenant may insist on the right to perform certain services itself (for example, janitorial) or the tenant may want the right to take over such services, or to force a change in the service provider, if the tenant is not satisfied with the services. The interruption in services provision also may be heavily negotiated, with the tenant seeking shortened grace periods, fewer permitted interruptions (for example, force majeure), stronger abatement rights, and termination rights.

Most Favored Nation

Large tenants often will try to obtain some sort of "most favored nation" clause stating that the landlord will not grant more favorable rights to other building tenants without also granting the same rights to the large tenant. These types of provisions can be very tricky. To make a deal with a potential future tenant, a landlord may need to grant specific concessions as part of a bigger economic deal. For example, if a particular tenant's hot button issue is the cost of parking, the landlord might agree to provide free or reduced price parking to the tenant in exchange for holding firm on a higher rental rate. In these situations, a most favored nation clause should not allow a large tenant to cherry-pick a specific tenant concession out of a bigger economic deal and then insist that it be entitled to that same concession as well. To the extent a landlord is willing to entertain this sort of clause, the landlord should seek to make the language as limited and specific as possible to avoid getting in trouble down the road.

Subordination, Nondisturbance, and Attornment Agreement

Because a large office tenant will likely have a significant, long-term investment in its office space and the leasehold interest could be a very valuable asset (depending on market rates), the tenant would not risk having its lease—and all of its hard-fought rights in the lease—terminated in the event of a foreclosure. As a result, virtually all significant tenants will require a nondisturbance agreement from any current mortgage or other security holder and also will condition subordination of the lease to any future mortgagee or security holder on the tenant's receipt of a satisfactory nondisturbance agreement.

These nondisturbance agreements almost always take the form of a subordination, nondisturbance, and attornment agreement (commonly referred to as an SNDA), which is often on the landlord's lender's form. Typically, these lender SNDA forms go well beyond the basic concepts of subordination, nondisturbance, and attornment and often contain material lease modifications, as well as significant limitations on a successor landlord's obligations and liabilities. For example, a typical SNDA form might state that a successor landlord shall not be liable for any of the landlord's construction or allowance obligations under the lease. These forms also frequently provide that some or all of tenant's termination, abatement, self-help, offset, and similar rights and remedies are not binding on a successor landlord. For a large tenant that has heavily negotiated its lease and obtained significant concessions from the landlord, these types of provisions are unacceptable. As a result, the SNDA will often need to be negotiated with the landlord's lender to protect the tenant's valuable lease rights and to ensure that a successor owner of the building respects those rights as well.

Conclusion

Whether one is on the landlord or the tenant side, negotiating a large office lease can be a very time-consuming and challenging experience. With some patience and thoughtfulness, however, and the help of a good team, it also can be a very interesting and rewarding one. n