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1Q2012

Real Estate Issues for High Growth Companies: Five Key Tactics for Managing Risks and Maximizing Returns

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Envision a company in an upward projectile — a high growth company. Year over year revenues are steadily increasing. Employee ranks are growing annually at north of 100%. Sales are doubling or even tripling each year. Through organic growth, merger and acquisition activity, or both, this company is moving to the next stage of its life cycle — it is becoming a big deal.

What are the real estate implications of this tremendous success? How should the company proactively manage them? If this company is growing organically, it will likely need more occupancy space before the end of its existing lease term to accommodate its expanding work force. If the company is in merger and acquisition mode, it will probably face geographic redundancy for some of its leases and possibly excess space in certain locations, in particular if it is gobbling up other companies in similar industries who tend to be located in the same areas where the company already operates. The company might also find itself expanding into new and previously unchartered geographic locations where it has no meaningful sense of prevailing rental rates and other market-based economic terms.

How should this high growth company best position itself to address these issues? How can the company maximize its increasing "real estate" clout in the marketplace? Here are five key tactics the company should employ to best manage the risks and maximize the returns from its real estate holdings:

1. **Prepare a Strategic Real Estate Plan.** The company should prepare a strategic real estate plan that reflects current and future real estate needs based upon its anticipated growth. This plan should be developed in coordination with the company's enterprise-level strategic plan and encompass the views of the company's leadership. It should include how the company's occupancy costs currently impact its overall budget and the stated objectives the company might have to minimize those costs. If the company determines that the reduction of occupancy costs is a strategic objective, then the plan should outline the possible approaches for achieving that goal. These could include reducing the amount of required space, relocating to less expensive neighboring jurisdictions (i.e., move from the city to the suburbs), employing innovative design tactics to use its space more effectively and efficiently and enhancing the use of technology for its core business operations (such as by transforming the company's offices to paperless environments, resulting in a dramatic reduction in required filing space). The plan should also contemplate the company's ultimate exit strategy as a general matter and specifically for particular geographic areas or business divisions. Future planning about how the company plans to implement its macro or micro exit strategies should be tied to the company's approach to its real estate. The company's strategic real estate

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plan should aim to enhance the company's existing operations, accommodate its future plans and at all times enable the company to closely manage its occupancy costs.

2. **Engage the Right Broker.** The company should engage a reputable broker with a dominant presence in the company's key markets. An attentive broker can play an integral role with the company's efforts to address its real estate goals and provide important insights for the company's strategic real estate plan. The broker should have the qualifications necessary to keep the company informed about market trends in each submarket in which the company operates or may need space. The broker should be engaged to help the company anticipate favorable market conditions to exploit the opportunities for locking in occupancy costs at the best points in the market. If the company faces redundancy in its real estate holdings in a particular jurisdiction, the broker should be tasked with proposing a plan to expeditiously eliminate duplicative leases and centralize the company's operations in that location. The right broker can contribute meaningfully to the company's strategic real estate plan.

3. **Develop a Leasing Tool Kit.** The company should develop a "tool kit" that includes a checklist of lease provisions to be pursued as a matter of company policy for every one of its occupancy leases. By including these strategic clauses in its leases, the company will be armed with the legal rights necessary to address its changing real estate needs, particularly as the company continues to grow. Below are suggested key lease provisions to be included in the company's leasing tool kit:

    - **Customized Lease Terms.** The company should seek maximum lease terms that best suit its anticipated expansion plans, as reflected in its strategic real estate plan. For example, the company should pursue shorter lease terms that include renewal options for leases in jurisdictions where the company may merge with or acquire another company. This will best position the company to eliminate redundant lease holdings. Conversely, longer lease terms (that usually result in a more favorable rental rates because landlords prefer them) can be accepted in locations where the company has a clear sense it will be operating for the foreseeable future.

    - **Early Termination Rights.** Early termination rights in leases permit the company to terminate the lease prior to the expiration of the stated lease term. Typically these rights require the payment to the landlord of an early termination fee (as compensation for the premature termination of the rental income to the landlord) plus the reimbursement of the landlord for any unamortized amounts of the tenant improvement allowance and brokerage commissions associated with the lease.

    - **Expansion Rights and Rights of First Opportunity to Negotiate.** Expansion rights and rights of first opportunity to negotiate enable the company to increase the size of its premises in a given building as space becomes available. An expansion right gives the company the option to lease specific (and often adjacent) space by a certain date. A right of first opportunity to negotiate permits the company to lease other space in the building, regardless of its location, as it becomes available. Both of these options enable the company to expand while keeping transaction costs down, since expansion space can be leased on the same terms as the initial premises and is often simply added as "additional premises" through a lease amendment. However, the rental rates and other economic terms for space resulting from the company's exercise of rights of first opportunity to negotiate will likely be based on the terms prevailing in the market at the time such space is leased by the company. If the landlord and the company cannot agree on the prevailing market terms, then they should resort to a "three broker" method process for the determination of these key lease provisions.

    - **Contraction Rights.** Contraction rights permit the company to reduce the size of its premises and the associated rental obligations under

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the lease. As with the early termination rights described above, these rights may be conditioned upon a payment to the landlord of some type of compensation for the loss of the future rental stream on the space that the company gives back, plus any unamortized tenant improvement allowance and brokerage commissions associated with that space.

- **Renewal Rights.** Renewal rights give the company the right to extend an existing lease term for a stated period. The company can negotiate in advance for the rental rates and other economic terms for the renewal term that would give the company some predictability in its budget (i.e., rent for each year of the renewal term could increase at the same 3% per year escalation rate that the company would pay each year during its initial lease term). Depending on the tenant-friendliness of the market, the company might have enough leverage to renegotiate for even more favorable rental rates prior to exercising its renewal options. If the renewal rental rates are not specified in the lease, the company should at a minimum have the lease specify that the "three broker" method will be used to determine the economic terms for the renewal term.

- **Relocation Rights.** Relocation rights in a lease enable the company to relocate its premises to another location in the building that may be adjacent to unoccupied space, thereby positioning the company to more efficiently consolidate its operations in the building as the company grows.

- **Sublease and Assignment Rights.** Sublease rights give the company the right to sublease all or a portion of its premises for less than the remaining term under the lease, and assignment rights enable the company to assign all of its rights and obligations under the lease for the entire remaining term. The company should have the unqualified right to permit its affiliates, subsidiaries and successors by merger to occupy the space without triggering any consent or other rights on the part of the landlord. Similarly, the definition of "assignment" in the lease should be scaled back so that merger and acquisition transactions engaged in by the company do not trigger landlord consent rights. If a landlord refuses to consent to a successor tenant, the company may be forced to breach its lease in order to consummate the merger or acquisition transaction, which could have a significant adverse impact on the company's balance sheet, particularly if the lease is for a substantial amount of space.

- **Telecommunications.** The company's leases should include telecommunications rights that are broad enough to enable the company to increase the broadband bandwidth serving the premises as needed to accommodate company growth, including expanding needs for video-conferencing and similar collaboration capabilities as new offices and locations are added to the company's real estate holdings.

- **Audit Rights.** The company should have the right in each of its leases to perform an audit of the landlord's calculations of operating expenses that may be passed through to the company, with clear remedies in favor of the company if it finds an error through this audit process (including reimbursement of associated audit expenses). Audit rights can position the company to strictly scrutinize its operating cost pass-throughs, in particular where the company has redundant space in certain locations.

4. **Engage an Innovative Architect.** The company should engage an architectural team that has a track record of working with, and designing innovative and forwarding looking real estate solutions required by high growth companies. The architect should suggest "new economy" approaches for efficient and effective management of occupancy space – such as office hoteling, use of touchdown areas and design of other collaborative spaces customized to fit the way the company's employees work together. The architect should also recommend ways that the company can eliminate vestigial space uses that the company has outgrown or will imminently outgrow (such as in the case of

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a law firm, a library whose singular purpose is to house books) or that digital innovations have rendered unnecessary. The design concepts proposed by the architect should encompass "green" features to enable the company to repurpose and reuse non-structural elements of the space in different ways that may be needed in the future, therefore maximizing the company's return on its tenant improvement expenses and positioning the company to act in a "sustainable" manner. These could include movable (i.e., non-structural) partitions and bays whose configuration can be changed as the company's use of its space changes with growth.

5. **Evaluate Economic Incentives.** As the company grows, it may gain significant market share and presence in a particular locale. The company should consider how it can take advantage of this clout to obtain favorable economic incentives from local governmental authorities by relocating its operations to their jurisdictions. These incentives can include tax credits and other financial benefits. The company should consult with its broker and other professional advisors to get a sense of what types of incentives are available in each location in which the company operates and should consider competing neighboring jurisdictions against each other to yield the best offerings for the company.

A high growth company can more effectively address the real estate impact of its expansion activities by preparing a strategic real estate plan that includes input from qualified professional advisors, including a reputable broker and an innovative architectural team. The development of a tool kit containing a checklist of essential lease clauses to be incorporated into every company lease will empower the company to pursue the legal rights it needs to best manage its real estate holdings in a cost sensitive manner. While the real estate issues faced by high growth companies are the proverbial "tail wagging the dog," as the company's organic growth or merger and acquisition activities should naturally be its central focus, sensitivity to the real estate implications of significant growth can empower the company to maximize the effectiveness of its operations and minimize costly operating expenses, driving significant value to the company's bottom line.

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