

Issues in Life Science Leases

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As landlords and tenants continue to navigate the uncertainties of traditional office and retail properties in the era of COVID, one asset type that has emerged as more resilient in this new environment is life science real estate.^[1] The spaces utilized by biotech and pharmaceutical companies, as well as medical research facilities, are highly technical, with site-specific functionality that cannot be replicated by remote work environments. As a result, life science real estate continues to attract tenants and property owners continue to invest in this sector. However, utilization of space for life science uses—wet and dry laboratories, warm rooms and cold rooms, and other activities—presents a number of specific issues for both tenants and landlords that should be considered in any lease transaction. Below is a summary of some of those issues from both a tenant's and a landlord's perspective.

TENANT ISSUES:

Use of the Premises: In general, the cost to build the core and shell, as well as the cost for tenant improvements, of a life science building is substantially higher than a traditional office building. Accordingly, both the landlord and tenant are committing significant capital to build out the space to the functionality required by the tenant. Ensuring that the tenant's intended use of the premises is permitted is critical, particularly when the landlord is redeveloping an existing property to convert to life sciences uses. Zoning, city and county ordinances, state and federal regulations and title restrictions can all impact the scope of permitted uses at the premises. While this presumably will be less of an issue for projects developed within districts or areas dedicated to life science functions, such as the Texas Medical Center in Houston, the significant capital outlays by landlord and tenant warrant comprehensive due diligence. The goal here is for the parties to know precisely what can and cannot be done at the premises and to avoid costly surprises.

Design and Construction of Tenant Improvements: As noted above, a life science premises will be highly technical and specific to the operations of the tenant's business. Unlike traditional office, use of the premises by a life sciences tenant is not typically uniform throughout the premises; one portion may be utilized for office by executive and administrative teams, while other areas within the premises may require separate climate controls or air circulation requirements depending on their specific uses. From the tenant's perspective, the design and construction of the premises needs to be efficient and cost-effective, while also resulting in a space that is technically functional and contributes to productivity and employee retention. Because the design and construction must integrate with the building and building systems, and because of the landlord's concern with contractor lien issues and disruption of other tenants, the build out of the premises will likely be managed by the landlord (or its property manager) and/or the landlord's general contractor will undertake the work. For the tenant, the work letter in the lease is critical and must clearly and comprehensively describe the process between landlord and tenant at each stage of design and construction so that the parties know their respective responsibilities, including cycles for review and approval of specifications and plans, change orders, the process and requirements for payment of contractors and disbursement of the tenant allowance, and, critically, who is responsible for delays in completion.

Utilities: One of the most important considerations for the tenant is the availability and redundancy of utilities. The tenant may be using high-consumption equipment and specific areas within the premises may need to be maintained within a specified temperature range. Chilled and hot water may need to be delivered to particular rooms within certain specifications. For a tenant, due diligence before executing the lease to confirm the specifications and capacity of utilities and building services, as well as the anticipated cost that will be charged to tenant for the same is critical. To the extent that a building lacks necessary capacity, a landlord will typically put the cost to acquire the additional capacity on the tenant, but will want to control the process to ensure integration with existing systems. For the tenant, both cost and timing are a concern. The lease needs to be drafted to address the concerns of both parties to ensure the agreed-upon utilities are available in the manner required by tenant. In addition, to the extent that the tenant has expansion rights, the tenant will want to confirm whether the required utilities are available in that space as well and, if not, understand the

scope of work and cost to update the expansion. An expansion right for space that does not include required utilities and that does not otherwise address the issue in the lease can result in significant unexpected costs for the tenant. Additionally, an interruption of utilities can have a severe, adverse impact on the operations and research of a tenant. For example, a failure of electricity or temperature controls could mean that critical specimens are lost or compromised. A tenant, therefore, will want assurance that backup systems exist and require that the landlord regularly test those systems. Alternatively, the tenant may require that it can install backup generators to ensure the continuity of its systems.

Security: While most leases include broad rights allowing for a landlord to access the premises, those broad rights in a life science lease can be problematic. A tenant may want to limit landlord's access to certain areas to protect confidential information or proprietary processes or may be prohibited by state or federal regulations from permitting a landlord from entering for health and safety reasons. The lease should be drafted to address those security concerns. The tenant may, for example, require that a landlord only be able to access certain areas if accompanied by a tenant representative. For areas restricted by regulations, the circumstances in which the landlord can access the premises should be set out and the tenant should have appropriate protections under the lease in the event that landlord does not abide by the terms of the lease for such access. Tenant should also make sure the lease includes a broad confidentiality provision that any process or technology that the landlord sees at the premises cannot be disclosed to any third-party except to the extent permitted under the express terms of the lease.

Assignments and Subleases: Despite the uncertainty of COVID, acquisitions and mergers continue within the life science sector and many industry experts expect significant activity once such uncertainty subsides.[2] The assignment and transfer provisions set forth in the lease need to be considered by the tenant in the context of its immediate and long-term business plans. A life science tenant will want to ensure that the lease provides for assignments or transfers of the tenant's interest in the lease without the landlord's approval in the case of transfers to affiliates, mergers or the sale of substantially all the tenant's assets. The last thing a tenant wants when it is about to be acquired is to have to negotiate the terms of a lease assignment. Additionally, although COVID's lasting impact on the trend of collaborative work spaces is yet to be determined, many life science companies will want to be able to sublease space to strategic partners or to incubate promising new companies. Flexibility to do so needs to be written into the lease.

LANDLORD ISSUES:

Tenant Creditworthiness: The high costs for a life science project means longer lease terms and higher rents, but also require that a landlord carefully assess its prospective tenant's creditworthiness to both fund the tenant's portion of construction costs and perform for the entire term of the lease. Many life science companies are new ventures and may lack significant financial history or real assets. More established tenants may be dependent on a successful clinical trial or regulatory approval to ensure continued financial viability. Landlords will want to consider various options to secure the tenant's performance. For example, a landlord may require that the tenant's share of construction costs be escrowed to assure availability of funds or, if the tenant is undertaking construction, require a completion guaranty for the tenant improvements. General lease guaranties from creditworthy affiliates can also be required. Additionally, in lieu of a cash security deposit, a landlord can require the tenant deliver a letter of credit. In the context of a tenant bankruptcy, a security deposit will be viewed as part of the debtor's estate and the landlord's ability to utilize the security deposit will be much more limited than the landlord's ability to draw on a letter of credit.

Hazardous Materials and Medical Waste: Life science tenants will almost certainly utilize or handle liquid and dry chemicals, biological specimens or agents, radioactive elements, and/or medical waste at the premises. While the lease should include specific remediation obligations for the tenant and broad indemnities to protect the landlord from liability concerning tenant's use of hazardous materials, the lease also needs to include landlord's specific requirements for tenant's handling and disposal of such materials. While simply stating that a tenant has to comply with applicable law in its handling of hazardous materials may be sufficient for an office lease, for a life science building in which tenants are routinely using and transporting hazardous materials or medical waste, landlords will want to be more proactive and set requirements and regulations around handling and transport of such materials. For example, a landlord may require that a tenant contract with a landlord-approved third-party for biohazardous or medical waste disposal. If the premises includes a vivarium, the landlord will want to set out rules and procedures for transport of animals to and from the

premises. The tenant can be required to submit scheduled compliance information to the landlord and the landlord should retain broad rights to test the premises to ensure no contamination has occurred.

Lease Expiration or Termination: Again, unlike a typical office or retail lease, a tenant under a life science lease will likely install expensive, sophisticated equipment at the premises. Both parties will want to clearly delineate in the lease those items that are considered personal property of the tenant and those that are considered fixtures and become the property of landlord at lease expiration. Those items that are fixtures may add significant value to the premises as the landlord seeks a new tenant for the space and the landlord will want to avoid any dispute as to whether the vacating tenant is entitled to remove the items.

In the event that a tenant defaults under the lease, the nature of life science operations at the premises may create additional issues for the landlord's when deciding a response. Whereas a landlord may not hesitate to lockout an office or retail tenant for failure to pay rent, in the context of a life science lease, locking out the tenant may not be as simple. The removal of sensitive equipment may require landlord engage specialists to ensure such equipment is not damaged. If systems within the premises require regular monitoring or if animals that need to be maintained are located on the premises, the landlord will need to carefully consider its actions to avoid claims of negligence or misconduct. Lease provisions should be included that allow the landlord to undertake any actions that the landlord determines are necessary to ensure health and safety and the good condition of the premises, including hiring third parties for services related to clearing or maintaining the premises. The lease should also include clear exculpation provisions with regard to any losses or damages resulting from the lockout or equipment removal.

CONCLUSION:

Life science real estate assets seem poised to continue to be a bright spot in the post-COVID era. Life science leases, however, present unique issues. Longer lease terms, higher rents and more intensive capital investment means understanding those issues during lease negotiation is critical to a successful tenant and landlord relationship during the term of the lease.

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[1] See Here Comes the Life Sciences Land Rush, Bloomberg City Lab, September 15, 2020, <https://www.bloomberg.com/news/articles/2020-09-15/life-sciences-labs-are-hot-covid-era-real-estate>

[2] See https://www.ey.com/en_us/ccb/life-sciences-mergers-acquisitions.

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