

SHEARMAN & STERLING



**CORPORATE HEADQUARTERS LEASING:  
GETTING STARTED**

BY

LEE A. KUNTZ

Internet Address: <http://www.shearman.com>

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599 Lexington Avenue, New York, NY 10022

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The phrase “a once-in-a-lifetime” experience conjures up images of dream vacations, exotic locales and great opportunities. So its application to the leasing of corporate headquarters space would seem, at best, misplaced. But, at the executive level, the handling of a headquarters commercial lease is often a first-time, and one-time, experience for the tenant’s senior executives. Generally (and perhaps intentionally), the term of the existing lease has extended well beyond the careers of the executives who handled it. Thus, any relevant experience gained in that process is not available to the organization. The challenge of a headquarters lease assignment is compounded by the fact that the counterparty, the landlord, generally has substantial and current experience in the negotiation of major (and lesser) leases and has a team of professionals with similar experience as well as substantial practice working together.

This article addresses how to get started on the process of handling a headquarters lease. In our experience getting started properly has a favorable impact on all of the remaining steps in the process. This article does not seek to define and resolve core issues; rather it seeks to provide a framework for managing the process required to assemble the internal and external expertise and data necessary to define and understand the issues.

Our focus will be on what we call a “headquarters” lease. This is intended to include leases of office space of significant size or importance to the tenant in that the premises will house senior executive and administrative staff of the business units involved. Such premises tend to be leased for relatively long terms, involve substantial investment in leasehold improvements and involve personnel who require a high level of service. Not unimportantly, the premises may represent a projection of the image of the business units, and, thus, the lease may involve intangibles which counterbalance standard economic issues.

We are assuming that you, the executive in charge of the lease assignment, have no substantial experience in commercial leasing and that there is no such person available to you within your organization. While we are making no assumption as to why you were so lucky as to be chosen for the assignment, we are assuming that the assignment is viewed as important.

The toughest part of getting started is generally figuring out where to begin. This is not a popular topic of self-help books or videos (although we will consider relevant offers) or often a featured article in the real estate section of the Sunday paper or even the subject

of a PBS miniseries. Moreover, while there are a myriad of articles on substantive lease issues (mostly in reasonably obscure publications a layman will not easily access), that information is not very relevant at the commencement of a leasing process.

We would suggest that the two initial goals of the project are:

- to build your internal and external team, and
- to define the essential criteria for the transaction.

The internal team must consist of those who can provide or can develop from within the organization the information needed to establish the criteria. This will include not just financial experts but also those who are able, on a quantitative as well as qualitative basis, to define and project the needs of the businesses which will occupy the premises. Our basic thesis is that assembling this team properly and understanding the premises criteria at the outset will provide you with a sound basis on which to execute the project. It is, of course, easier to state the obvious than to achieve it.

We will assume, as is generally the case, that there is no obvious internal team available to you. There are presumably a couple or three colleagues likely to be helpful and maybe even available. We would certainly recommend drafting them into the initial stages of the process. However, if we are correct in our assumptions that neither you nor your available and willing colleagues have significant experience in commercial leasing, the starting point most often is to find an outside expert. One’s current landlord may be an expert but, perhaps, not impartial. The other logical source are those professionally active in the commercial leasing business, such as real estate brokers, real estate lawyers and architect/space designers.

Our preferred starting point, for what may be discernible reasons, is the real estate lawyer. We will start there but with an acknowledgment that most executive officers will not intuitively start there (until they have read this article) and that it is actually possible (but, of course, not as efficacious) to start with one of the other relevant professional groups. Even if persuaded by this article to place your first call to us, we would recommend (as we would for each professional group) that you and your initial team interview several qualified candidates. This interview process has two important goals — to determine the candidate that you feel (and we use that verb intentionally) is the most qualified and to test the relevant questions

and issues particular to your search to help refine and focus them. This interview process is a significant part of the preliminary data collection and education process for you and your internal team. It will also help you formulate which colleagues you will need to have available to you for the assignment.

Your initial interviews should cover:

- the qualifications of the law firm and the particular lawyers, including specialties such as construction, telecommunications, outsourcing and other relevant service contracts, finance and other areas not directly within a real estate practice but perhaps relevant to your assignment;
- the proposed staffing of the assignment in the context of the contemplated timetable for the transaction and the reasons for such staffing (e.g., is there an appropriate mix of seniority that seems relevant to your needs); and
- fee estimates, including special fee arrangements (such as fixed or capped fees), but keeping in mind that the one-time dollars “saved” up-front may be modest compared to the dollars which may be “saved” over the term of a headquarters lease.

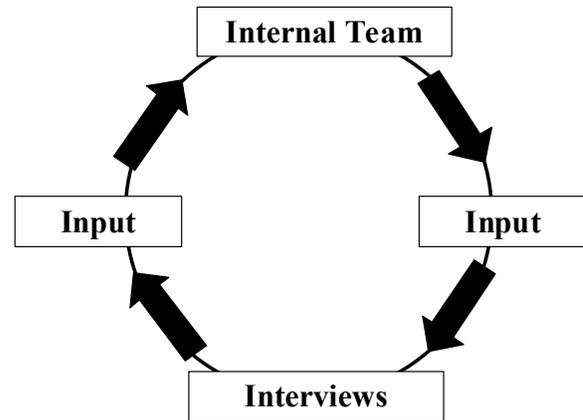
Beyond these basics, your interviews should cover:

- views on the market and special market opportunities, as qualified leasing counsel should be active in the market;
- special deal or financing structures that may be relevant to your situation;
- an explanation of the basic process and recommendations as to other professionals (including, for the very pushy, other counsel) who might be interviewed to fill the various roles relevant to the process;
- identification of typical gating issues — economic, substantive and timing — which you should program into your own project plan; and
- articles and other publications for clients which will provide you with relevant background.

Each of these questions, with required variations, can be asked of each professional group you interview. Moreover, they are part of an iterative process whereby the more you learn about the process, the

more you will know to ask about it. Also, the more you learn, the more you will be able to ask of your own organization as to its real needs and objectives for the new premises.

**Exhibit 1**



Having retained the lynchpin of the outside team, the next steps involve the assembling of the balance of the external professional advisory group and your internal team. The latter will match up as counterparts to, or information conduits for, the former. The external professionals will include a leasing broker and an architect/designer and may, and in our view should, include a programmer, one or more engineers or specialized consultants as relevant to the planned installation and operations, and a construction consultant and/or a general contractor. If your organization has outsourced staff functions (mail, insurance, premises management, telecommunications, etc.), parts of your internal team may come from outside your organization. Such persons may be able to fulfill both the internal and external roles, and you may decide that pursuing that model is both efficient and efficacious.

Before reviewing the balance of the external roles, it is worth reflecting again on the essential nature of the lease transaction which is to provide a relatively long-term accommodation to a dynamic environment. One need only reflect upon the fundamental changes in how business is done and space occupied over, say, 15 years to see the challenge of providing for the next 15 years. Think about your business units as constituted in the mid-80’s and today. In this context the value of having a broad range of advice should be evident. In addition, in order to be in a position to make sound choices, you and your internal team must be able to challenge the bases on which your business units operate and the bases on which they propose to operate in the future and the space they occupy and

propose to occupy in the future. This requires a vigorous debate among people with sufficient, albeit imperfect, information but with an understanding of your goals and objectives.

## Leasing Broker

There are three primary tasks for the leasing broker: the presentation of space, the negotiation of the basic business terms of the transaction and the coordination of the lease negotiation. There are some professionals (or real estate firms) which provide a broader range of services. While these additional services may be relevant, even important, factors in your decision-making process, the essential process of finding the appropriate space alternatives on reasonable (given the then market) terms is the critical role of the leasing broker.

As with counsel, an interview process with several qualified professionals is an important part of the selection process. The interviews should cover:

- the qualifications of the leasing broker's firm and of the particular broker, including: (a) experience in assignments of similar scope for companies in your line of business, (b) experience in the specific markets or sub-markets in which you are interested, (c) timeliness of the experience and (d) availability of ancillary support groups within the firm in such areas as programming (determining and projecting space needs), technical engineering and building operational matters, project management and insurance;
- the proposed approach to the assignment on a step-by-step basis through a timeline;
- the proposed staffing; and
- the pricing of the brokerage services and such other services as may be relevant to your project.

Your interview should also cover the more general issues noted above in respect to your interviews of counsel: views on the market, special structures and alternatives to a commercial lease transaction (purchase, financing lease, synthetic lease, etc.), comments on the process, recommendations of other professionals, identification of gating issues and market reports and other written information.

There are two matters which are widespread in the industry but which you may find unusual: (i) most

leasing brokers (and their firms) represent both landlords and tenants — even in the same transaction and (ii) the commissions payable on a leasing transaction are generally paid by the landlord. There are, of course, leasing brokers who do not represent landlords, and there are even some who only accept compensation from their tenant clients. It is possible to adopt an approach of only using an adviser who has neither of the foregoing “conflicts”. However, the prevalence of these two practices in the real estate industry is such that to adopt that approach is to exclude a large number of qualified professionals and firms from consideration. On the other hand, you must, of course, be comfortable with your leasing broker, and you should explore these matters with those you interview.

Another factor in this regard is that leasing broker commissions are generally based upon a percentage of the rent payable. The more you pay, the higher the brokerage commission (and that commission is payable by the landlord who receives the higher rent). A number of very large users may negotiate alternative fee arrangements (such as a specified dollar amount per square foot leased). Moreover, in individual transactions which are sizeable, one may negotiate a discount off the standard commissions. In either case, there are issues as to how such reduced commissions will be reflected in the rent (assuming the commissions remain payable by the landlord) or how discounts will be “shared” with the tenant (as such fee splitting generally violates the applicable real estate brokerage law).

By now the leasing brokers will have pointed out:

- that counsel and other professionals (architects, engineers, etc.) represent landlords as well as tenants;
- that doing so gives a professional a better understanding of the dynamics of the transaction;
- that some professionals (engineers, for example) represent the building as well as the tenant (this is unusual for counsel who would require an express waiver from each party to represent a landlord and a tenant in the same transaction); and
- that the fees of others often vary with the size of the transaction.

These are all valid points, and they provide a relevant context when judging whether the “conflict” issues discussed above are in fact material to your decision.

Even if the law of your particular state does not require that a brokerage agreement be in writing, it is important to have a written agreement. Among the items to be covered are the scope of the assignment, the duration of the assignment, the fee arrangements and termination rights.

Leasing brokerage engagements are almost inevitably on an “exclusive” basis, which means that the broker will be entitled to compensation upon the signing of a lease whether or not the broker locates the particular premises or negotiates the particular deal. Because of the potential for conflicting brokerage claims as well as the general requirement of landlords that a tenant’s broker provide authorization to represent a tenant, non-exclusive arrangements are problematic.

This is not to say that arrangements with respect to special situations are not made. For example, you may have approached or been approached as to particular premises and thus may want or need that those premises be excluded from the scope of the engagement. You may also have renewal rights under your current lease. If those premises are a viable alternative, you may require or desire special arrangements on the commission payable in respect of an exercise of renewal rights.

It is also customary for a leasing broker to seek protection as to premises shown to a client during the term of the leasing broker’s engagement if, following expiration or termination of the engagement, the client leases any such premises. This provision (a “run off” clause) generally requires that a specific list of such premises be provided promptly after an agreement expires or is terminated and limits the post-agreement protected period to a reasonable period of time.

We give these couple of examples to illustrate that, whether or not you have first retained counsel in the process, you should definitely have counsel advise you as to the brokerage agreement. Although this does not have to be the counsel for the leasing transaction, it should be counsel experienced in handling brokerage agreements because the selected broker and the broker’s counsel certainly will be.

## Other Professionals

As alluded to above, there are several other professionals who may be relevant to your assignment. Our view is that it is helpful, if not essential, to have these professionals included as part of the initial team for-

mulating your space requirements. These professionals include:

(a) **Programmer.** This is a professional who assists in defining your current space needs and projecting your needs for the future. Your brokerage firm or architectural design firm may provide this service or you may secure it from an independent professional. The programming process can be quite detailed and time-consuming as it can involve surveying the heads of each business unit or sub-unit as well as all support units. To complicate matters further, there are evolving and often conflicting concepts of space usage (tele-commuting and hotelling, open-space planning vs. offices, etc.) as well as changing views on support functions (cafeterias, day care, health facilities, etc.).

Many of these matters must reflect overall policies of your organization rather than simple current and projected business unit headcounts. A professional programmer will assist you in formulating and resolving these issues and ultimately in defining the space required to meet the needs of your business. Included in this process should be at least preliminary conclusions as to layout requirements (classic examples being trading floors and other installations which require raised flooring, special cabling, high power capacity, special cooling and ventilation and the like), stacking plans (which units should adjoin other units) and locational requirements (such as whether back-office functions should be located with front-office uses).

The end product of the programming, at least as relevant to the initial phase of your assignment, should be not only a definition of your space requirements but also an indication of related technical requirements.

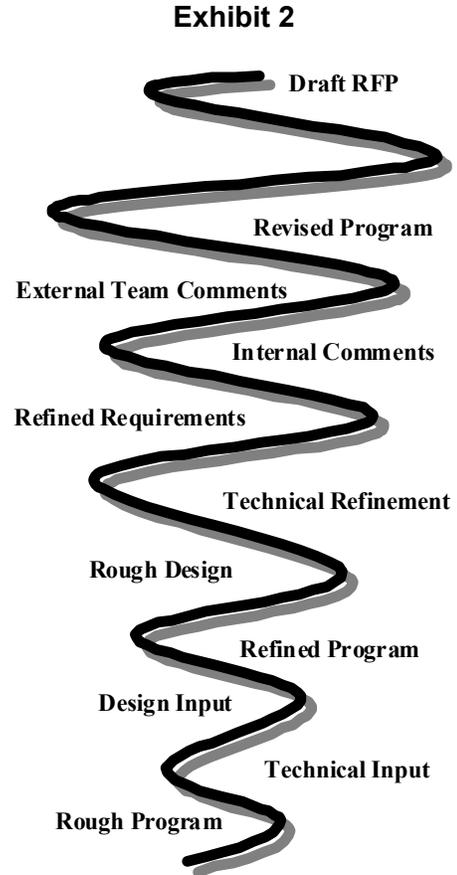
(b) **Engineers.** Using this term broadly to cover all technical consultants, you should have sufficient input at the initial phase to be able to define your technical requirements for the premises. Obvious areas to explore include structural issues (for example, floor loadings and inter-floor stairs), air circulation (for example, special cooling for high density areas), electrical power, telecommunications and data transmission, security, environmental, health-safety, special services (for example, food), and vertical transportation and traffic and materials flows (how you move people and things).

(c) **Architect/Designer.** In the initial phase, the architect/designer will provide further input into the programming and technical requirements as well as translate such requirements into your general and special layout requirements. These requirements may well have a significant impact on your search as they may eliminate a number of buildings or make buildings non-competitive on a cost basis.

In addition, the architect/designer will provide benchmarks against similar businesses (for example, are you programming for adequate support space) and benchmarks for evaluating alternative premises (measurements on a per square feet per employee/desk/professional basis). This part of the process can be an early warning sign that you need to test more vigorously the conclusions of your programming or otherwise reevaluate the organization's approach to space utilization.

(d) **Construction.** The construction professional will provide input as to timing, costs, process and the particular issues presented by your requirements and the various premises available to you. This professional will also be able to analyze special construction requirements presented by particular buildings (for example, access to loading docks or freight elevators) and by particular landlords. Some of this information may seem less than currently relevant. However, it is not unusual for one or more construction issues of economic or timing importance to be identifiable early in the process.

Overall, this process can be viewed as one whereby the staged input from each professional adds to the overall data base and to the defining of your requirements, as illustrated by Exhibit 2.



### Premises Criteria

Starting at the foot of Exhibit 2, the initial output from the internal and external team you have assembled are the essential specifications for the assignment. This is not just what you should be looking for but why. The latter is important because most headquarters projects end up in a series of compromises among the relevant criteria. Thus, it is important to understand the source and "weight" of each criterion. There are seemingly an endless number of criteria to be dealt with, reflecting the complexity of most major business operations. Some of the more significant ones are:

(a) **Location.** Beyond ascertaining that the premises are proximate to the CEO's favorite golf course, more often than not location is a function of the current location of the business, which in turn is often a function of history as well as established lines of communication with customers, suppliers and the like. If you truly have an open agenda as to location, there emerges a whole new layer to the premises search and, in fact, the need for some different skills and experience. In order to maintain some

focus to this article, we have assumed a premises search within a prescribed metropolitan area. Even then, one should consider, albeit in a narrower fashion, many of the same factors as with a broader search, including: (i) transportation and traffic for employees, customers and suppliers; (ii) labor pool (including educational, vocational and other community support to increase or enhance the labor pool); (iii) safety, health, housing, schooling and other employee concerns; (iv) proximity to customers, suppliers and others involved in your daily business; (v) governmental grant and benefit programs (including financial and tax benefit programs); (vi) electric power and other utility packages; (vii) area cost structures (including individual tax burdens); (viii) industry concentrations or the lack or undesirability thereof; and (ix) the area real estate market.

(b) **Size and Type of Space.** Your programming and design work should delineate your current and projected space needs and configurations as well as any special requirements. As to size, the industry has at least two measurement standards — rentable and usable. The former is the basis upon which rent is calculated. In most communities rentable area is computed in accordance with standards developed by the Building Owners and Management Association (“BOMA”) — a nationwide, landlord trade association. In selected areas, Manhattan being the prime example, local custom supports alternative and even more landlord-favorable measurement approaches.

Usable, also called “carpetable”, area is the square footage on the floor that you can actually occupy for your business. This measurement excludes core facilities and other building elements which may serve the floor but are not available for tenant use.

The difference between rentable and usable measurements is generally referred to as the “loss factor”. In the BOMA measurement approach, there is a correlation between the public and equipment areas of a building and the loss factor, as the primary focus of the BOMA approach is to allocate such areas pro rata among the tenants. Thus, that loss factor reflects in a general way the space efficiency of a particular building. However, efficiency is only one element to consider as more extensive public amenities in a building may be an important criterion in your search.

This building loss factor is not the only loss factor with which you must contend. There is also the issue of how efficient a building’s particular floor plate is for your intended use. Within a range, this is a function of your program and design criteria, but it is also a function of the floor plate itself. Some shapes are less appropriate than others for, say, perimeter office layouts. Your design professional can provide a preliminary layout for each building seriously considered and can also provide an overall loss factor (or efficiency rating) for each such building.

To compound the complexity of the loss factor issue, actual floor sizes will also affect your efficiency in two major respects. First, the space requirements of your functional business units may indicate that a certain size of floor is more adaptable to your use. Second, as wholly occupied floors are inherently more efficient, floor sizes indicate the current and future “units” in which space will be available. Thus, very large floors may require that you take more space at any given time than you will need.

Beyond floor sizes, building sizes also affect efficiency. In larger CBD buildings, one is generally looking at vertical stacking of business units, whereas in suburban campus settings, one may have to consider horizontal stacking — that is, occupancy of multiple, smaller buildings or a single building with an extremely large floor plate.

These issues also need to be considered across the timeline of the lease term, which raises the issue of what length of term (with renewal options) you should be seeking. The term issue is in part a function of the marketplace and in part a function of your business plan. A specific part of your programming report should be a projection of your business units’ needs, and thus space requirements, over a reasonable timeframe. Most such projections will show business growth (how many business unit heads project downsizings?) and thus increased space needs. These needs are generally covered by use of expansion options and/or expansion rights of first refusal or rights of first offer. As any such options or rights encumber the landlord’s flexibility, they are an important part of the negotiation of the overall lease package.

(c) **Timing.** At any given time, the window within which you must reach a decision and conclude a lease will obviously dictate the universe

of choices. If your project is like most, you are already weeks, if not months, late in starting. In tenant-favorable markets, this may not be a critical element, but in balanced or landlord-favorable markets your challenge has just increased significantly. Thus, it is important to understand the process and to develop a realistic schedule. It is likewise important to focus the planning process that this article espouses on the general timing issue as well as on specific long lead time items and gating issues.

(d) **Financial Concerns.** There are obviously a range of financial issues involved in a major lease project, beginning with identification during the interview process of an order of magnitude of the costs involved in your project, the portions thereof likely to be borne by the landlord (or “rentalized”) and, if relevant, the alternatives for dealing with the balance.

The primary cost item, on a present value basis, will presumably be the rent. This will largely be market driven and should be within a range that the leasing brokers you interview identify. This cost will also depend upon your estimated space need, the particular operating cost and real estate tax attributes of the building you select, your particular requirements for overtime or special services and intangibles, such as a requirement for a prestige address.

The next most significant cost item will likely be the cost of constructing your leasehold improvements. Except in the tightest landlord markets, landlords provide tenants with a leasehold improvement allowance and with some period of time without payment of rent within which the initial improvement construction is to be done. The improvement allowance and free rent period are generally market driven and thus can be estimated by your leasing broker. In significant lease transactions, these are heavily negotiated items. In any event they are obviously linked to the rent as part of the economic package offered by a landlord. While rent and allowance and free rent dollars are not fungible to landlord, most will have some ability to trade among these economic components.

The third largest item is the moving expense which will be incurred. In significant relocations, this amount may be materially greater for accounting purposes as all employee severance and relocation costs may be chargeable as a project cost. This is also an area which must be

carefully analyzed as it may involve less than obvious issues. For example, it may not be possible to disrupt trading floor operations by attempting to relocate and reuse existing equipment, with the result that a wholly new installation may be required.

In addition to the foregoing, there will be a number of other costs, including counsel and consulting fees. Even regular operating expenses, such as stationery costs, can become significant budget line items as letterhead, forms, business cards, etc. must be reprinted or, for computer-generated items, re-programmed.

You may wish to consider alternative means of financing of some or all of the projected costs of the lease project. Some costs may be financed or “rentalized” by the landlord. In the case of build-to-suit and other new construction, portions of these costs may be wrapped into the building financing. In other cases, techniques, such as synthetic leases, may be available to finance leasehold improvements.

As part of this overall analysis, you will want to understand not only the NPV and cash flow attributes of the transaction but also the GAAP accounting treatment. As indicated above, relocation costs may be a major factor in the accounting for the transaction. There will, of course, be others.

In addition to dealing with the costs which you will bear, you will wish to ascertain early in the review process with each landlord whether it has the financial resources to cover the costs to be borne by it. As a commercial lease is almost always nonrecourse to the landlord beyond its interest in the building, this may be a major issue if there is no ascertainable source of funds. In some cases, the landlord will have specific credit arrangements available which can be structured to backstop the landlord’s direct liability. For example, where the landlord has just acquired the building, the acquisition financing may have contemplated advances for releasing the building. In other cases your “collateral” may consist of an offset against future rents, forcing you to finance the landlord’s obligation should it default.

(e) **Physical Criteria.** A significant part of your planning process will involve developing the requirements for the new premises. These will cover a wide range of building and third-party

services, most of which will have to be covered in specific lease provisions. Some of the more important of these are:

(i) **Telecommunications and data transmission, including specialized lines, microwave and satellite.** You will require access for your service providers as well as rights to locate and service equipment. In the nature of such things, as an increasing number of tenants have sought to upgrade these services, landlords have looked to charge for the building facilities (riser space, equipment space and roof space) required to provide the services. Buildings may also vary widely in their capacity to handle these upgrades for the cost thereof.

(ii) **Electrical power.** With the advent of deregulation, it can be anticipated that the whole area of electric power provision will evolve rapidly. This provides a range of opportunities which landlords may not as yet have comprehended in the building systems. Tenants which are large users of electric power may be able to negotiate very favorable rates from their electric service companies (ESCOs) — the now and future retailers of electric power. On the other hand, landlords (directly or through industry purchasing cooperatives or through their real estate service companies) may be able to purchase electric power equally economically. Control over the purchase of electric power from ESCOs, both financially and physically, is a developing issue in commercial leasing.

(iii) **HVAC.** Many businesses have significant requirements for special heating, ventilation and air conditioning requirements, some of which may be provided by independent, tenant-supplied systems and some of which may require the support of existing building systems. For example, while it may be more efficient for a tenant to provide its own special systems for very high use areas (conference facilities, trading floors and the like), the running costs may be moderated by using building-supplied chilled or condenser water.

(iv) **Health/Safety.** The needs and concerns here range from special systems to support specialized uses (auditoria may require special fire exits; cooking facilities may require special venting) to the level of

compliance with the Americans with Disabilities Act to issues related to asbestos, “sick” building syndrome and other employee concerns. There are likely to be a score of such matters in a major lease transaction, each one of which will involve issues as to cost and control.

(v) **Special Uses.** Your business units may have specialized requirements for presentation, training, laboratory and similar facilities, and you may have broader requirements for employee food service, on-premises health care, exercise facilities and the like. Again, these types of special uses raise physical issues as well as cost issues.

(vi) **Security.** Your security requirements may range from control of lobby access to having secure vault areas for the storage of items of high value (geological reports, source codes, securities, etc.).

(vii) **Delivery/Access.** If your business units have significant deliveries (to and from) or a significant level of visitors, you may have to secure special rights to use building loading docks and freight and passenger elevators, to have a special reception area in the lobby or to have a separate entrance to the building.

## Request for Proposal

Although there are a number of means of conducting your space search, a common format is the request for proposal (RFP). This is where the hard work and team-building recommended in this article come together. Essentially, the RFP allows you to invite the selected landlords to address the full range of requirements, costs and issues which are generated by the various space and business unit criteria you have developed. Although the market custom differs from area to area, the RFP approach is directed to resolving many, if not most, of the core issues at the preliminary stage (meaning before a draft lease is produced) of negotiations.

Perhaps just as important the RFP process allows (actually requires) you to pull together the disparate information you have collected and present it in a manner which collates (and one hopes coordinates) the input from all team members. Not all of this information is presented in the RFP; for example, financial projections are not. But the framework of the

projections is formatted into the RFP so that the landlords' responses will address those factors on which you need information.

A sample form of RFP is attached. The sample is at approximately the mid-point of detail used in RFPs. In some markets, substantial detail as to important lease provisions is included. In other markets the

RFP will be a broker's letter of perhaps 3 or 4 pages highlighting only the most basic deal terms.

At this point you should be prepared to embark upon the actual process of selecting space. While the joys of the business and lease negotiations await you, you should be in a position to appreciate the points at issue and to weigh the various compromises that will be required.

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Mr. Kuntz is a partner in the Property Practice Group of Shearman & Sterling. This article is a companion piece with: "Before the Millennium: Commercial Office Leasing in the 1990s" by John L. Opar, also a partner in the Property Practice Group of Shearman & Sterling.

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