

# The data centre BATTLEGROUND

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issues when signing a data  
centre lease

With the global data centre letting market becoming more established, experience is making both owners and occupiers increasingly sophisticated in their approach to lease negotiations. The fact that both parties are now more aware of what they want and how they want to achieve it often leads to lengthy and fractious negotiations, resulting in unacceptable and costly delays.

This article examines the key areas of contention that owners, occupiers and their advisers encounter when negotiating a data centre lease.

## Lease v Services Agreement

When drafting a contract for the provision of space in a data centre, the first consideration will be the form of agreement to be used. Will the building owner grant a lease to the

occupier (establishing a relationship of landlord and tenant) or is the arrangement to be simply a commercial contract for the provision of services?

The answer to that question is far from straightforward. There are many factors to consider, including:

- Legal capacity – if the owner itself holds the building under a lease, it may prohibit sublettings or contain significant restrictions on use.
- Exclusive possession – the occupier is likely to require certainty as to the physical area available to it to house its expensive equipment. However, an owner may require the ability to relocate fundamental infrastructure during the term of the contract, meaning a services agreement (containing 'lift and shift' provisions) is its preferred form of contract.
- Tax – the creation of a lease may give rise to a tax liability. The amount

of tax (SDLT in the case of leases granted in England and Wales) is likely to be substantial if the rent is high. A properly-drafted services agreement can avoid or mitigate the occupier's exposure to tax, so this may be a material factor in deciding which form of agreement is appropriate.

- Jurisdictional issues – the type of contract to be used may be dictated by particular jurisdictional matters. For example, in Germany the parties' ability to agree a valid, freely-negotiated agreement is limited by the German Civil Code and familiarity with the Code is therefore essential when reaching agreement on commercial terms.

- Commercial factors – there could be other, less obvious, issues that influence the decision on the form of contract. A building owner may not want to grant a lease because its business model dictates that it only enters into co-location-type



agreements, for example. There may also be political reasons to avoid a lease, such as in some South American jurisdictions where subsisting leases are vulnerable to changes in law or regulation imposed by unpredictable governments.

### Rent review

The vast majority of data centre leases contain fixed rental uplifts (or adjustments in line with a recognised index, such as the CPI) rather than open market rent reviews. The main reason for this is the lack of comparables and the consequent uncertainty around how the judiciary would interpret open market review clauses.

The rent review mechanism is invariably agreed during commercial negotiations. However, some owners are now seeking to agree fixed uplifts but with scope to increase the rent further if commercial circumstances materially change (the owner's landlord imposes an unexpectedly large increase in the rent payable under the head lease, for example).

The owner's desire to be able to adjust the rent in these circumstances often does not come to light until the legal document is being negotiated. It is therefore crucial that the commercial terms are clear on rent review to avoid any unnecessary contention during legal discussions.

### Power provision and charging

An occupier's starting position is that usually that the resilience of the data centre should be 2N (i.e. double the normal operating requirement). However, during legal negotiations, it occasionally transpires that the building's redundancy is, in fact, a lower standard (N+1, for example), which may not be compatible with an occupier's business requirements. This highlights the importance of thorough technical due diligence prior to the commencement of lease negotiations, at which point the occupier is likely to have committed significant expenditure to the project.

Whether the owner is entitled to make a profit on the power it charges the occupier is a commercial issue. However, jurisdictional matters will need to be taken into account when drafting and negotiating the power charging mechanism. For example, in territories where the provision of electricity is monopolised (by TEPCO in Japan, for example), there is frequently a debate around power later in negotiations where it becomes apparent that the owner is not willing or able

to offer the cost-effective and transparent power solution expected by the occupier. Therefore, advisers need to understand such issues when negotiating both the commercial and legal terms relating to power provision to avoid any unpleasant surprises further down the line.

### Alienation and dealing

As with all commercial lease negotiations, careful consideration will need to be given to each party's ability to deal with the property. The owner will want to deal freely with its interest while maintaining sufficient controls on the occupier in order to create and maintain a saleable investment.

Conversely, an occupier will want maximum flexibility (allowing it to underlet to group companies and to licence portions of the property to co-locators, without the owner's consent) but will seek to restrict the owner's disposal options as far as commercially and legally possible. This is to ensure that the provider of the essential services is the party in which the occupier has confidence based on its pre-contract due diligence.

Both parties will need to be aware of these competing aspirations when negotiating and be willing to offer concessions if these fundamental issues are not to threaten the deal.

### Limitations on liability

When considering the liability profile of a lease, the owner will invariably seek a cap based on the financial 'value' of the contract. This is often unacceptable to an occupier, as it will want any limits on liability to be sufficiently punitive to encourage good behaviour while at the same time ensuring that it will be adequately compensated should unforeseen events occur.

The occupier may also seek unlimited liability in particularly sensitive areas (such as intellectual property and confidentiality) where this is legally possible.

Again, each party will need to understand the other's legitimate concerns and should be willing to compromise. Otherwise, entering into the contract may become commercially unattractive, resulting in the breakdown of negotiations.

### Remedies for breach

There is broad agreement that the failure of, or diminution in, any of a data centre's crucial services (namely uninterrupted power, cooling and control of humidity) should give rise to financial penalties over and above



those available at law. However, that is often where concurrence ends and there are likely to be debates around the contractual availability of other remedies.

Should there be a penalty regime for more minor breaches? Will the occupier be granted a right to terminate the lease if there are persistent failures? Who will bear the risk if the owner's ability to provide the core services is affected by a force majeure event? A well-represented party will have clear and strong arguments supporting their responses to each of these questions and a resolution to these issues is therefore likely to turn on business factors, outside of the legal arena.

The prevalence of the leasehold model of data centre ownership means that there are an increasing number of well-established providers and users in the market. This has resulted in the adoption of internal policies that are often inflexible, meaning that disputes are inevitable during negotiations. However, a balanced approach will be key to resolving these issues and to ensuring that the parties enjoy a prosperous business relationship while the lease is in place.