

Cordells Rompotis

Briefing Note – August 2017

DATA CENTRES

Contractual Real Estate Issues- Notes for End-Users

Introduction

Companies are increasingly moving their data centre requirements offsite. Benefits include more efficient use of office space and cost savings in the form of cheaper rents for non-office space, which can be located outside of the main business districts; economies of scale through the sharing of power and cooling; and greater operational security through the provision of diverse power and cabling routes to the data centre, and extensive on-site security. There are however risks which need to be managed in order to ensure continuity of service and data security. This paper discusses some of the material legal issues relating to real estate which should be checked when taking space in a data centre.

The points we discuss below are of particular relevance in respect of co-location space – that is, defined physical space in a data centre owned and operated by one or more third parties who will be providing power, cooling and security. Such space may be a separate suite, or a secured cage within a larger room.

Overview

This paper highlights the key legal considerations which a customer (**End-User**) of a data centre should be thinking about. It will also be relevant to owners and operators of a data centre in considering the issues they may need to negotiate in their contractual documentation, and the liabilities which they may need to back into their other contracts (for example with the developer of the data centre).

We will assume that the transaction structure involves a land owner (**Owner**), who owns the land by way of a Government Lease; a data centre provider (**Operator**), who manages the data centre and who has entered into a lease and/or licence and/or management agreement

with the Owner; and the End-User, who will enter into a number of contracts with the Operator, as set out below.

The End-User will need to investigate the title of the Owner and Operator, and in particular how their interests may come to an end. We consider first the title issues to which particular attention should be paid and then move on to consider the main legal issues likely to arise in the End-User's key contracts. Those contracts will ordinarily comprise:

- Lease and/or Licence of the main data centre space and ancillary rights to use risers, plant rooms, roof space etc.;
- Service Level Agreement setting out service standards. These will include the requirements for an uninterrupted supply of power and the regulation of temperature and humidity, and will provide for service credits in the event of a service failure;
- Agreement for Lease or Fit-Out Agreement, containing obligations relating to the construction of the data centre (whether it is a new-build or a conversion rather than a data centre which is already fully operational) and potentially providing for the installation of cabling and other elements of the fit-out by the Owner or Operator for the End-User.

Title and termination

The End-User's interest is only as strong as the weakest link in the contractual chain. The title of the Owner and the Operator must be carefully investigated to ensure that all interests have been validly granted, and all rights and consents necessary to operate the data centre are in place. The End-User must then consider how those interests might be terminated, which could lead to business

interruption and potentially the termination of the End-User's own rights.

Initial title due diligence

- In Hong Kong, the Owner will own the land by way of a Government Lease. The user clause should be carefully checked, particularly if an existing industrial building is being retrofitted to create a data centre. If the user clause is industrial, this does not permit a data centre use and a waiver or modification of the user clause will be required from the Lands Department. In addition, note that using the premises as a business continuity/disaster recovery suite would require an additional waiver, as this is more of an office use. Please refer to our separate paper "Briefing Note- Data Centres- Hong Kong Land Supply and Entitlement Issues, Greenfield Sites, Converted Industrial Buildings and Rock Cavern Development" for further details on waivers and modifications. If the user clause has been breached, the Government will be entitled to re-enter and terminate the Government Lease, although it will usually give a grace period for the breach to be rectified.
- Is the use permitted under the Outline Zoning Plan? Again, our paper "Briefing Note- Data Centres- Hong Kong Land Supply and Entitlement Issues, Greenfield Sites, Converted Industrial Buildings and Rock Cavern Development" contains further details on this.
- If the data centre only comprises part of a building which is in common ownership, check to ensure that data centre use is permitted under the Deed of Mutual Covenant. If the data centre needs to use any of the building common parts (as defined in the Deed of Mutual Covenant), particularly if exclusive use is required, the consent of the building manager and the other co-owners may be required (if they have the power to give the requisite consent). Please refer to our separate paper "Briefing Note- Data Centres- Hong Kong Land Supply and Entitlement Issues, Greenfield Sites, Converted Industrial Buildings and Rock Cavern Development" for further details on issues which may arise in a multi-owned building.
- Does the data centre site benefit from all necessary rights to run power, water and cabling into the site by diverse routes, together with all necessary rights of access?

- Have the appropriate consents been obtained from the Buildings Authority for the construction of the data centre/the conversion of an existing building into a data centre? In addition to the possibility of being required to carry out remediation works which could prevent the use of the premises as a data centre or significantly disrupt operations, unauthorized building works constitute a title defect and can have a significant impact on value.
- What restrictions on alienation are contained in the Government Lease? For example, at the Hong Kong Science and Technology Parks, sub-letting, parting with possession and sharing occupation is prohibited, causing difficulties for any co-location facility operating there. The End User should also check the interest granted by the Owner to the Operator, to ensure that it does not contain any additional restrictions on the Operator's ability to deal with the premises and to check whether the Owner's consent is required. Please refer to our separate paper "Briefing Note- Data Centres- Hong Kong Land Supply and Entitlement Issues, Greenfield Sites, Converted Industrial Buildings and Rock Cavern Development" for further information on the Hong Kong Science and Technology Parks.
- Note that if the Operator does not have a lease itself, it will not be able to grant a lease to the End-User unless it is entitled to act as agent for the Owner in the granting of leases. This entitlement would need to be evidenced.
- In some cases it will be necessary to structure a direct contractual relationship between the Owner and the End User.

Termination and remedies

If any of the above requirements are not satisfied so that the interest is terminated, the End-User could suffer business interruption and potentially the loss of its right of occupation. The various solutions to these issues are set out in the annexed table. The ability of the End-User to negotiate these remedies will depend on how much space it is taking and how important the income stream from the End-User is to the viability of the data centre.

Contractual rights and negotiation

As said, typical documents which will be negotiated between the Operator and the End-

User include the Lease and/or Licence, Service Level Agreement and Fit-Out Agreement.

It is important to ensure that the documents are treated as a unified suite of documents which stand and fall together.

As discussed above, it may also be appropriate for the End-User to have a contractual relationship with the Owner in certain circumstances. This will depend on the nature of the deal and the End-User's negotiating strength.

We look at each of these contracts in turn, but will first consider why an Operator and an End-User should always try to obtain a Lease rather than a Licence.

Lease or Licence?

The main differences between a lease and a licence are as follows:

Lease	Licence
A proprietary interest in land which binds successors in title.	A contractual right which does not bind successors in title. Successors in title can terminate the licence. The Licensor should be obliged to obtain a direct covenant in favour of the End-User from any successor in title to comply with the Licence.
Ability to apply for relief against forfeiture.	No right to apply for relief against forfeiture. Negotiate a cure period in which the breach can be remedied, with the right to terminate only kicking in if the breach is incapable of remedy or has not been remedied by the expiry of the cure period.
Tenant has exclusive possession of the premises.	Licensee does not have exclusive possession (this means that it will not be able to exclude the Licensor; areas may be used in common with third parties; and there may be restrictions on the times and manner in which the premises may be used)

Whether or not an interest is a lease or a licence depends on whether, as a matter of fact, exclusive possession of the premises has been granted. If exclusive possession is found to have been granted, the interest will be a lease, even if the document calls it a licence.

The End-User will require exclusive occupation of any areas which it needs to ensure are kept secure, and should therefore insist on a lease of these areas. Rights to use ancillary areas such as risers, plant rooms and roof space, are also fundamental to the End-User's ability to operate the data centre. Such rights could be granted as rights ancillary to the Lease, which can be exercised in common with other users. Access to relevant areas may well be controlled by the landlord for the protection of all users, but this is not a reason in and of itself for the rights to be granted by way of licence. However, in Hong Kong landlords often insist on granting such rights by way of licence. If the landlord does insist on a licence then an End-User needs to try to negotiate protections to address the limitations of a licence. The End-User should also ensure that if it has termination rights under the lease, it has the same rights under any licence.

Key contractual issues to cover in the Lease and/or Licence

In addition to the points relevant to licences discussed above, an End-User in a data centre context should also consider the following (note that we have not highlighted other more standard points which the End-User may look to negotiate):

- **Term** – due to the capital intensive nature of the fit-out and the need to minimize business disruption, End-Users will want to negotiate a term of a suitable length. Note there are no statutory rights of renewal of business tenancies in Hong Kong.
- **Expansion rights** – End-Users often want the ability to be able to expand. If space is taken at different times in the building, this may cause problems with the rent review clause, if this has not been carefully drafted. Surrender rights may also be appropriate in certain cases.
- **Rent review** – if there is a longer term, or upon exercising an option to renew or expansion right, a new rent may need to be determined. Data centre leases often provide for a fixed uplift because of the difficulties in finding appropriate comparables by reference to which the open market rent can be determined. If, however, an open market rent review is

to be used and the End-User has more than one lease in the building (e.g. because it has exercised expansion rights), the rent review clause must be drafted to avoid creating a "special interest" which could lead to an above-market rent (i.e. the argument that a tenant will pay more for premises demised under one lease because it has other premises in the building). An End-User must also ensure that any works which it paid for (even if carried out by the Operator or Owner on its behalf) are not rentalised. These issues can be drafted for, but a number of different clauses work together and care must be taken to ensure the correct result is achieved.

- **Ownership of equipment** – items affixed to the premises belong as a matter of law to the landlord, unless they relate to the tenant's trade and can be removed without damage. The End-User should clearly identify which items belong to it and can be removed by it at the end of the term.
- **Reinstatement** – the usual position in a lease is that the premises should be yielded up in a bare shell condition or that the landlord can elect which items it wishes to be removed. However, in a data centre context this may not be appropriate as the removal of extensive racking and cabling is likely to be expensive, and the tenant may wish to remove items and re-use them elsewhere. Also partial removal can be more complex and expensive than complete removal.
- **Alterations** – sufficient flexibility should be built into the alterations clause to permit the installation of racks and cabling on an ongoing basis. Look out for a requirement to use the landlord's contractor (usually more expensive) when carrying out works which connect into the main building services.
- **Maintenance and defects liability** – responsibility for repair and maintenance needs to be clearly set out between the parties, and the End-User may want a maintenance and testing schedule to form part of the lease/licence.
- **Security protocols** – the End-User is going to want to restrict access to its premises and will often agree detailed security protocols with the landlord to govern rights of access.
- **Alienation** – in Hong Kong alienation is usually prohibited, which usually captures change of control. This should be carefully looked at in the context of how the data centre is to be used.
- **Caps on liability** – see "Service Level Agreement" below.
- **Landlord's sale and redevelopment clause** – Landlords in Hong Kong often seek to include a sale and redevelopment clause, entitling them to terminate the lease on giving a specified period of notice in the event that the premises are to be sold or redeveloped. In the context of a data centre the End-User should delete such a clause as it is inconsistent with the capital intensive nature of the fit-out and the length of time it may take to find and fit-out alternative premises.

Service Level Agreement (SLA)

The SLA is essential in ensuring that the data centre operates to the required standard and sets out what happens in the event that it does not. Any failure in the supply of critical services could lead to an outage which could have a material impact on the End-User both financially and from a reputational standpoint.

The End-User's lawyers and engineers/IT specialists will need to work closely together on the SLA. Key points to look out for include:

- **Services schedule** - the technical team will work to agree a services schedule, which will list out the services to be provided (which will include power supply and the regulation of temperature and humidity) and the critical parameters against which performance of the services will be measured. They will also be involved in categorizing the severity of a failure to provide the services to the specified standard, which will inform the remedies which should be available to the End-User. The Operator is likely to want some carve outs from its obligation to provide the services to the required standards, for example due to a force majeure event. These carve outs should not entitle the Operator to exclude liability arising from its own negligence or failure to perform.
- **Service credits** - in the event of a service failure, the End-User should be entitled to service credits which will operate to reduce the service fee payable. There may be a cap on the level of service credits which are available.

- **Termination rights** - for severe or repeated service failures, termination rights may be appropriate. If the SLA is terminated, the End-User must also have the ability to terminate all other documents associated with its occupation of the data centre.
- **Cost of power** - this will fluctuate depending on the electricity market. The End-User should ensure that the basis upon which it is charged for power is clearly set out in the SLA, and should look out for any restrictions on its ability to consume power, which should be negotiated to reflect its operational requirements (taking into account how these may change over time).
- **Exclusions and caps on liability** - the Operator will not be prepared to accept liability for all the losses which could stem from a service failure. It is therefore common to see exclusions of liability and caps on liability. As noted above, the Operator should not be entitled to exclude liability arising from its own negligence or failure to perform, but its liability is still likely to be limited by a cap. The End-User should look to manage its risk by taking out appropriate business interruption insurance.

Agreement for Lease/Fit-Out Agreement

This is particularly relevant when the End-User enters into a contractual commitment whilst the data centre is still under construction. The End-User will want to know what is being built; when it will be built by; and how defects will be remedied. The contract will need to cover all of these points, and allocate liability for any failure to perform. The contract should also cover any works which are to be carried out by the Owner or Operator for the End-User, and the End-User may also want to negotiate early access so that it may start those works it is carrying out itself as soon as possible.

The key for the Owner or Operator is to look at their agreement with the End-User in conjunction with their building contract so as to be able to manage risk. If the building contract has already been let before the End-User is involved, it becomes more difficult for the End-User to negotiate certain protections. As before, the End-User's negotiating strength will also be determined by how much space it is taking and the importance of its income stream to the viability of the data centre. There are solutions and compromises which can be negotiated.

Completion of the data centre to the required standard

- **Construction contract** - the identity of the contractor is relevant to the outcome of the development, and the End-User may be able to negotiate approval rights or a short-list of permitted contractors. The End-User may also want approval rights over the terms of the contract. The Owner/Operator will be keen to ensure that the End-User does not delay the process and will want to control the cost of construction.
- **Design and specification** - the End-User will want to agree the specification to be attached to the construction tender documents, and if there is to be further design development may also want approval rights at later stages. The End-User may also seek approval rights over the brands of generators and other plant and machinery to be used. The Operator will again want to ensure there is no delay, and that the End-User's requirements as to design do not increase the cost of construction (unless the End-User is contributing towards the cost).
- **Payments** - if the End-User is contributing towards the cost of any plant or works, it should require certificates from the Authorized Person that the sums have been expended, accompanied by invoices.
- **Inspections** - the End-User will want the ability to inspect the works, and to attend regular update meetings. The Operator will want to limit the number of inspections and to deal with any liability issues which may arise for delay or damage.
- **Completion** - completion will trigger the term and rent commencement. The End-User therefore does not want completion to be unilaterally determined by the Operator, as the premises may not have been completed to an acceptable standard. Practical completion under the construction contract alone may not be sufficient, because the required works and standard to which they must be completed may not necessarily be the same. The parties may therefore agree what is meant by "practical completion", and in particular specify the testing and commissioning that is to be carried out. The End-User will want its technical team to be present when the building is inspected, and when the testing and commissioning is carried out. This is an

area which will often be heavily negotiated by the parties.

- **Defects** – there should be an obligation on the Operator to remedy defects which are notified to it within a specified period. The length of the period will be a matter for negotiation, and the Operator should ensure that it can require the contractor to remedy defects for the same period.

Completion on time

- **Timetable** – the parties should agree a date by which the building is to be completed (there may also be interim milestone dates).
- **Termination rights** - there will usually be a second, later, long stop date after which the End-User will have a right of termination. Termination rights may also be agreed if the works are suspended or abandoned. Termination of one contract should terminate all contracts entered into between the parties.
- **Extensions of time** – the Operator will want to be able to extend the agreed dates if events happen which are outside of its control, but should not be entitled to an extension if the contractor is in default – it is for the Operator to manage the contractor. From the Operator’s perspective, the definition of force majeure (which gives rise to the extension of time) should be the same in all contracts. The Operator should be entitled to extensions of time if the End-User causes any delay e.g. if it is slow in giving any approvals, requires variations or has early access. If the date for delivery is postponed, the term and rent commencement dates should also be postponed.
- **Early access** – if the End-User negotiates early access so that it may start its own works before the main contractor finishes on site, there is an increased risk of delay due to the possibility of interference with the main contractor’s works. To the extent early access is agreed to, the contract will need to cover the End-User’s liability for damage and delay in the event of disruption to the main building works.

Liability for breach

The contract should clearly set out liability for breach. As with SLAs, there are often exclusions and/or caps on liability.

- **Liquidated damages** – it is common for the parties to agree liquidated damages for delay, structured by way of additional rent free periods. The ability to sue in damages will then be excluded. Liquidated damages can be advantageous because there is no need to prove loss.
- **General damages** – if liquidated damages are not agreed, the End-User will ordinarily be able to sue in damages (and would be obliged to prove and mitigate its loss). However, one would expect to find exclusions of liability and carve outs for economic and consequential losses. There may also be caps.
- **Termination rights** – usually arise if the long stop date is missed, or if the works are suspended or abandoned. They may also arise if specified performance tests fail.

Conclusions

Special considerations come into play when taking space in a data centre. It is crucial to treat all contracts as a unified suite of documents which stand and fall together. The issues raised above should be considered in a technical and operational context, and it is possible to arrive at negotiated compromises in respect of them.

Corporate real estate, leasing and data centre advice forms one of the core elements of Cordells Rompotis’s practice. For full details of these services please see our website: www.cordells.com.hk

Legal Notices

This Note does not constitute legal advice and you should not take, or refrain from taking, any action as a result of it. No responsibility can be taken for losses arising out of any such action or inaction. Always seek advice from a solicitor in respect of any legal issue which you may have.

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Appendix

Termination and Remedies

Termination	Possible remedies
<p>Breach of the Government Lease - entitles the Government to re-enter the property bringing the Owner's interest (and all other interests) to an end.</p>	<p>The Owner can apply to the court for relief against forfeiture. This is a discretionary remedy and the likelihood of relief being granted will depend on the nature of the breach and whether it is capable of remedy. During an application to the court for relief against forfeiture, the Owner may generally remain in occupation of the property so the data centre could continue operating.</p>
<p>Termination of the Operator's interest:</p> <ul style="list-style-type: none"> • Effluxion of time • Breach • Insolvency, disclaimer and exercise of the mortgagee's power of sale 	<ul style="list-style-type: none"> • The length of the Operator's interest should be checked as part of the title due diligence. • If the Operator has a lease, it will also be able to apply for relief against forfeiture (see above). • If the Operator's interest is a licence or management agreement, there is no right to apply for relief against forfeiture. The Operator should negotiate (and the End-User should check for) cure periods in which it can remedy the breach, with the right to terminate only kicking in if the breach is incapable of remedy or has not been remedied by the expiry of the cure period. • Although it is unlikely that the lease itself could be disclaimed as it is a proprietary interest in land, a liquidator of the Operator may be able to disclaim a service level agreement or a management agreement if it constitutes an onerous contract. An onerous contract is one which it costs more to perform than the revenue which is generated. • If the premises are mortgaged, the consent of the mortgagee should be obtained to the grant of any lease (if required) otherwise the mortgagee will be able to exercise its power of sale and sell free of the lease. <p>The End-User could seek to protect itself against the risk of termination of the Operator's interest by:</p> <ul style="list-style-type: none"> • Taking a lease or licence directly from the Owner. • Negotiating a direct agreement with the Owner entitling the End-User to be notified of any breach and granting the right to step-in and remedy the breach. • Agreeing with the Owner minimum requirements (e.g. as to financial strength and data centre experience) for any new Operator, or even obtaining approval rights. • Obtaining an indemnity from the Operator, but this will depend on covenant strength and would not prevent business interruption.