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Lab tested, lawyer approved: Strategies for life science leasing

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It is a good time to be in the life sciences business—and therefore it is a good time to be in the business of leasing space to those in the life sciences business.

Significant inflows of capital have created increased demand for specialized lab space, especially in the regional hubs of San Diego, California, Raleigh, North Carolina and Boston, Massachusetts. Many landlords in this space are specialized with purpose-built facilities; however, the lower vacancy rates and generally higher rents available in this segment of the market have spurred other commercial property owners to convert generic office space into labs. Biotech leases, unlike other classes of commercial leasing, cannot be “rinse and repeat” given the unique nature of each tenant’s business and, crucially, because in many ways these leases represent partnerships between landlord and tenant and not contests of leverage on every point. Therefore, it is important for market participants, whether specialized or not, to understand the distinctions between general commercial leasing and biotech leasing.

We highlight below certain broad categories to be particularly focused on as you negotiate your first (or fiftieth) lease in this space.

Tenant improvements

Buildouts of biotech space are much more complex than a typical office lease and more specifically tailored to each tenant (including whether specific infrastructure such as cold rooms, tissue culture rooms, specialized ventilation or floor reinforcement is needed). Therefore, the design and construction of tenant improvements will necessarily be more of a collaboration between landlord and tenant than in other asset classes. Parties should focus on the following (in addition to economic terms):

1. approval process for architects and contractors;
2. who will prepare the plans for the space (and what level of input and approval is granted to the other party);
3. coordination between the parties in connection with obtaining permits and approvals required for occupancy; and
4. what specific costs are covered by the tenant improvement allowance.

Given these specialized buildouts, it is important that the parties negotiate the requirements for removal of tenant's improvements at the end of the term. Leases should clearly state what specific equipment must be removed and the condition of the space delivered to the landlord at the end of the term (typical "broom clean" language will not be sufficient). Depending on what is required, this restoration could be a very costly process, and the tenant will want to have visibility (and reserve for the associated costs) from the outset.

Security deposit

Landlords are in the business of protecting their returns, and making a significant investment in tenant improvements without some security in the event of a tenant default is not part of the playbook. The customary approach of a security deposit of six to twelve months of base rent and/or a guaranty from a creditworthy parent will often not work because tenants do not want to provide the cash (as it shortens cash runway and ties up funds that could be used to grow the business) and do not have a guarantor to offer. There are two commonly used alternative options that can satisfy the needs of each party:

- **Security deposit burndown:** The tenant will initially put up a "market" security deposit, with such amount (or a portion thereof) to be returned to the tenant upon the achievement of defined milestones, generally reaching EBITDA thresholds or raising certain levels of new unrestricted equity financing. In addition, some burndowns are triggered by tenant performing its financial obligations under the lease for a defined period.
- **Letter of credit:** If the tenant has sufficient collateral, tenant's bank can issue a letter of credit to secure tenant's obligations for a fee of approximately one percent per year of the face amount. This removes the risk of trapping cash but satisfies the landlord's concern for additional security. The issuing bank will often require the maintenance of cash balances to secure the letter of credit, so the tenant must make a calculation whether that amount is ultimately lower than the amount of cash security required by the landlord or provide collateral to the issuer in some other form (for example, a lien on equipment).

The landlord will also want to ensure itself that it has sufficient visibility into the tenant's finances so it is not surprised by a default. As such, landlords will often require that the tenant provide financial information throughout the term of the lease and maintain the ability to declare tenant's EBITDA, net worth or valuation (based on a post-commencement funding round) dropping below a certain level to be a default.

Hazardous materials

Tenants in this space often bring with them a dramatically increased risk of environmental contamination. As such, it is essential that the parties establish a baseline for the use and condition of the property throughout the lease and at expiration. Since neither party wants to be responsible for contamination it did not cause, parties will often also obtain environmental reporting regarding the premises at the beginning of the term.



At the conclusion of the term, it is essential for the landlord to require a decommissioning report from the departing tenant confirming that no hazardous materials remain at the premises.

Parties should focus on the “permitted use” provision of the lease to govern during the term. This provision should place upward limits on what tenant may do, i.e., limiting work performed above a certain Biosafety Level as established by the Department of Health and Human Services (DHHS). In addition, the lease should distinguish between “Dry Lab” and “Wet Lab” uses, and apply different levels of landlord approval and scrutiny to each use. Landlords may also consider adding a provision requiring tenants to purchase and bring onto the premises certain chemicals on a “just in time” basis, so dangerous materials are not on premises for any longer than necessary.

At the conclusion of the term, it is essential for the landlord to require a decommissioning report from the departing tenant from a “Licensed Environmental Professional” confirming that no hazardous materials remain at the premises, among other customary certifications. In addition, landlords should require that any specialized users (such as those using radiation) obtain required approvals or reports from DHHS or the relevant public health department as part of decommissioning.

Assignment and subletting

The business of biotechnology is not for the faint-hearted, and the risk of failure is very high. A distressed tenant may attempt to sublease its space to other parties. In addition to standard terms around sublease or assignment such as requiring that the tenant remain primarily liable, landlords will want to focus their attention on tightening the criteria for approval of subtenants (e.g., the requirement of a certain net worth or a guaranty from a creditworthy parent). Further, as rental rates continue to rise as demand far exceeds supply, landlords should focus on capturing any positive difference between the rental paid by their tenant and proposed to be paid by a subtenant. Often the parties will agree to split this “bonus rent”, but tenants should define this amount as excluding costs incurred with pursuing the sublease (e.g., alterations to the space, brokerage commissions payable by tenant). Finally, landlords should require the ability to recapture space if the tenant desires to sublease. In a competitive marketplace, landlords may want to substitute a distressed tenant attempting a sublease for a new tenant that they have a full opportunity to diligence, financially and otherwise.

Not all is doom and gloom, however. Tenants should ensure that the lease permits, without consent, affiliate transfers (e.g., to effectuate a corporate restructuring in connection with a round of fundraising), a “change of control” of tenant that may occur in connection with an acquisition or an IPO. The consent of a landlord to these events should not be the tail wagging the (very lucrative) dog.

As a specialized segment of the commercial property market, it is no surprise that the leases for biotech users will be specialized as well. Market participants can be successful by applying their knowledge and experience from general commercial leasing and focusing on the essential distinctions within this space (with the help of their lawyers, of course).

To discuss these issues, please contact the author(s).

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