Issues to Consider in Building Out Tenant Improvements

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Editor’s note: The following is an update of an award-winning article that first appeared in the former NACORE magazine, the Corporate Real Estate Executive.

This article focuses on issues that often surface in connection with those leasing transactions where the structure contemplated by the parties is to have the landlord build out all or a portion of the tenant’s proposed improvements; when the landlord contributes to the costs of the tenant improvements in the form of a tenant allowance; when the landlord also agrees to obtain financing on behalf of the tenant to cover the balance of the costs of the tenant improvements; and when the parties contemplate to speed up the construction time by agreeing to work side by side.

Although many advantages flow from such a cooperative undertaking, there are also disadvantages. The primary disadvantage is that more often than not, if the landlord builds out the tenant’s space, the tenant’s bargaining position with its landlord/contractor becomes diluted, and is weaker than the recourse it would have if it were to contract with a construction company that customarily assumes 100 percent responsibility for construction risks.

The following issues are most often debated in these transactions.

What Are Permitted Uses for the Tenant Allowance? The size of the tenant allowance, and its availability, are market driven. In a tenant’s market landlords generally offer such a financial package. In a landlord’s market, on the other hand, the availability of the tenant allowance is largely dictated by factors such as the desirability of the tenant from the standpoint of name recognition, building legitimization, and the like.

Terms and conditions relating to the tenant allowance most often negotiated are whether the allowance may be used for anything other than hard costs, how is the allowance to be funded, whether the landlord has to post a letter of credit or other security to give comfort to the tenant that proceeds of the allowance will indeed be available, and if the landlord defaults in its funding obligations, whether the lender providing financing for the building can be required to assume the landlord’s payment obligations.

Landlords generally prefer to have the tenant allowance be used only for hard costs, and then only for those hard costs that involve improvements that the tenant does not have the right to remove at the end of the lease term. Tenants, on the other hand, prefer to have the tenant allowance usable for soft costs as well, such as architectural and engineering design fees, legal fees, expediting fees, consulting fees, and the like.

Landlords will want the tenant allowance to be paid in a lump sum at final completion of the tenant improvements, while tenants will want the allowance to be paid to them up front. The compromise usually reached is to have the landlord advance portions of the tenant allowance as work progresses, on a pari-passu basis with the tenant. This issue need not be addressed in transactions where the landlord is also the tenant’s contractor, and has no incentive to withhold payment until completion of construction. The reason for the lack of incentive is because it is making progress payments to itself, as distinguished from risking making payments to a non-performing independent third-party contractor hired by the tenant.

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On the issue of letters of credit or other security to assure that funds will be available, my experience has been that although it is important for a tenant to raise it, it is just as important for the tenant not to insist on it. What the tenant can insist upon in return, however, is to require that the obligation to make such payment be binding on anyone succeeding to the landlord’s interest in the building.

Who Owns the Tenant Improvements Funded Through the Tenant Allowance?
This is an important issue because it affects what the tenant may remove at the end of the lease term. It also impacts many other issues in the lease, such as insurance, routine repair obligations, and repair obligations after a casualty. The ideal way to resolve this issue is to have the parties agree that to the extent that the tenant allowance is used to fund the costs of tenant improvements that are not removable by the tenant after the lease term, then such non-removable tenant improvements should be considered landlord’s property, should be insured under landlord’s property insurance and the landlord should assume the obligation for both routine repairs and repairs after a casualty.

When Is Rent to Commence?
There is a distinction between the commencement date and the rent-commencement date in most leases where the space is not ready for occupancy on the lease execution date. The period of time that lapses between the two, is usually the period afforded the tenant to build out its space and open for occupancy.

In leases where the landlord is not the tenant’s contractor, the issue of rent commencement is not debated at length because the tenant’s failure to cause its independent third-party contractor to complete by a certain date is not the landlord’s problem, and rightfully should not have an adverse economic impact on the landlord. In such leases, the tenant usually gets the benefit of a fixed rent abatement period, which extends to the landlord the comfort of a fixed rent commencement date.

In leases where the landlord is also the tenant’s contractor, the issue of rent commencement is addressed at length in the context of many issues, one of which is who determines when the space is available for occupancy. Landlords usually insist on having the landlord’s architect make the determination, while tenants attempt to inject impartiality by requiring a joint determination.

Whether the initial determination is joint or not, one important issue to address is to make sure that such a determination is not final, and if there were to be a dispute, an expedited dispute resolution mechanism would be in place to resolve it. Another important issue to address is that if the tenant’s case prevailed, but while the dispute was pending the tenant had to pay rent (which is usually the case), then the landlord should be required to rebate such rent, with interest.

Often the work to be performed by the landlord on the tenant’s behalf does not cover all the specialty improvements needed for the finished space. The tenant, through independent third-party contractors unrelated to the landlord, usually performs these. Landlords usually take the position that rent should start when the landlord has finished all its work, even if the tenant is unable to occupy the space for its intended uses. Tenants, on the other hand, usually maintain that rent should not start, until all tenant improvements are completed and the entire space is ready for occupancy.

There are no hard and fast rules on this issue. It is reasonable, however, for a tenant to insist upon shortening the downtime by getting permission to work side by side with its landlord. This request is usually granted, but when it is, it raises a host of new issues that have to be negotiated, such as whose work takes priority (landlords usually prevail on this issue), indemnification for personal injury and property damage (which usually is a win-win situation from the perspective of both parties because these are insurable risks), the tenant having the right to the use of hoists, loading docks, elevators, electricity, and heat necessary for the performance of its construction, and, in exchange, pay tenant’s equitable share of landlord’s so-called general conditions costs (which should get resolved simply on the basis of actual cost pass-throughs), and delays in completion of landlord’s work and tenant’s work discussed below.
What Constitutes Landlord Delays and Tenant Delays?
The issue of delays is very important. Delays fall into two categories: One is landlord delays, and the other is tenant delays. The issues usually negotiated center around what constitutes tenant delays and landlord delays, what flows from the occurrence of either, and what is the interplay between the two.

As anticipated, landlords insist on a very broad definition for tenant delays, and a narrow definition for landlord delays. For instance, in a 500,000-sq. ft. (46,451-sq. m.) built-to-suit transaction I recently negotiated, an attempt was made by the landlord to include in the definition of tenant delays, any work reflected on the tenant’s plans that in the reasonable judgment of landlord constituted so called long-lead items. This included special air-conditioning, electrical and plumbing require-
ments, cooling towers and related equipment, emergency generators, electrical switch gear and related equipment, cafeteria, executive dining room and related kitchen facilities, custom built-in cabinet work, lighting fixtures, and the like. Also included within the definition of tenant delays were tenant’s plans not being delivered to landlord on time, tenant making changes in its plans, tenant failing to exercise approval rights within a fixed period, tenant’s contractors delaying landlord’s contractors, and the like. Those advocating the landlord’s position take the position that all of this sounds reasonable because the landlord is only attempting to protect its rent commencement date. However, this is not reasonable because by the time tenant delays and other construction issues with potentially adverse cost consequences are considered and negotiated, the rent commencement date is already locked in, with no ability to look back and renegotiate.

I also would like to caution against a very narrow definition of landlord delays, usually advocated by landlord’s counsel. In the 500,000-sq. ft. matter mentioned earlier, the definition of landlord delays expressly excluded delays in completion due to the acts or omissions of landlord’s contractors and subcontractors. The position put forth in support of the exclusion was that such delays constituted force majeure events over which the landlord had no control. This would have been an absurd result in a transaction where the landlord insisted on being the tenant’s general contractor, and its compensation as a general contractor was at market rate.

Tenant delay issues should be addressed fairly, and the landlord should agree to grant to the tenant a right of self-help to step in and finish the work, as well as the right to terminate the lease, if the work is not completed by the landlord by an agreed upon drop-dead date.

Should the Landlord Be a Construction Manager or a General Contractor?
For the reasons set forth below, landlords prefer and in many cases insist on being a construction manager rather than a general contractor, while the reverse should hold true for tenants.

The construction management project delivery system has been around for decades, and has fallen in and out of favor over the various economic cycles. Although some hybrid structures have evolved over the years, in the conventional and most widely used construction management approach, the construction manager is an agent of the owner. As such, the relationship of the parties is founded in common law principals of agency, and the construction manager/agent is immune to liability unless it acts outside of the scope of its agency, or is negligent. In determining negligence, the standard of care applied is a professional fiduciary standard that generally boils down to best skill and judgment.
This is in direct contrast to the traditional general contracting project delivery system, where the general contractor’s legal relationship to the owner is that of an independent contractor, the general contractor being strictly liable for risk-free, economic, and timely performance of the construction.

Although it’s not readily apparent, the differences in the risks and responsibilities assumed by a construction manager and a general contractor are numerous and staggering, with the following being only a couple of highlights:

- A general contractor is responsible for completing the work on time, while a construction manager is merely required to come up with a schedule, and try to have the sub-trades comply.
- A general contractor holds primary responsibility for all defective work, materials, and equipment, while a construction manager is merely required to endeavor to guard the owner against defects in the work of the sub-trades.
- Unlike a general contractor, a construction manager is not responsible for construction means, methods, techniques, sequences, and procedures employed by the various sub-trades; nor for cutting, fitting, and patching to make sure that the several parts of the work fit together properly.
- Unlike a general contractor, a construction manager is usually not responsible for verifying that the field measurements used by the sub-trades in their shop drawings are accurate.
- Unlike a general contractor, a construction manager does not guaranty the contract price.

What Are the Appropriate Warranties When the Landlord Is a General Contractor?

Assuming that the relationship of the landlord to its tenant is that of a general contractor relationship, another very important issue to address is warranties.

As a general contractor, the landlord should be responsible for defective work in two respects. First, the lease should provide for the customary one-year warranty against defects, obligating the landlord to correct any defects discovered by the tenant within one year after the tenant takes occupancy. Second, in addition to the one-year warranty obligation, the lease should contain an express covenant from the landlord, stating that all materials and labor will be of good quality and free of defects. Such a covenant should also expressly state that the landlord’s obligation for defect-free construction is not limited by the one-year warranty. The effect of this is to preserve the tenant’s right to bring an action against the landlord for breach of contract (after the lapse of the one-year warranty period).

While acceptable to a general contractor, most landlords vehemently argue against the inclusion of such clauses, and offer nothing more than to have whatever subcontractor warranties in effect at completion are assigned to the tenant. Such a result should be acceptable to a tenant only if it is permitted to participate in the drafting and negotiating of the construction contracts to assure that the warranties assigned are in proper form, and to preserve the tenant’s ability (as a third-party beneficiary) to bring a breach of contract action against the subcontractor during the applicable statute of limitations period.

These are only a few of the major issues that must be addressed in a leasing transaction where the landlord is also the tenant’s contractor, with the responsibility of building out all or a portion of the tenant improvements. The colossal mistake often made by many involved in these transactions is to defer consideration of these issues, rather than addressing them up front, at the inception of negotiations, when other issues of economic importance, such as rent, renewal options, exit strategies, and lease term are addressed.

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Susanna S. Fodor has more than 25 years of experience in commercial real estate. Ms. Fodor is a member of several organizations, including the American College of Real Estate Lawyers, the American College of Construction Lawyers, CoreNet Global, the Urban Land Institute, and the American Arbitration Association. Ms. Fodor is a frequent lecturer and author on real estate issues and is a founding editor of the Journal of Corporate Real Estate.