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The Pitfalls for Landlords to Avoid in Leases Involving New Construction

By Ira Fierstein

New construction always involves myriad unknowns — cost and timing are two of the biggest. However, if you add the complication of negotiating a lease at the same time, the problems quickly multiply. This article addresses some of these issues and provides advice for the landlord's use to avoid ending up in a situation where the lease becomes unprofitable.

The most obvious issue the parties face when negotiating a pre-construction lease is deciding on the date that the landlord is obligated to deliver possession of the completed premises to the tenant. It is important for the landlord to negotiate something less than absolute completion. The delivery date should therefore be determined when the landlord *substantially* completes its work in accordance with required plans. Substantial completion means completion sufficient to allow a tenant to take possession and operate the space, but may require the completion of minor punch list items. Similarly, if the landlord is required to deliver a certificate from an architect or contractor, the certificate should be one of substantial completion. This allows the clock to start ticking for determining when the rent begins and when the tenant is required to open for business. The landlord can complete any punch list items after the delivery.

Often, the lease will require the landlord to obtain a certificate of occupancy to trigger the commencement date. It is important to verify that the municipality will actually issue such a certificate and will do so in a timely manner. Some jurisdictions take as long as 6 months to do so. If the tenant is performing substantial tenant improvements, it is likely that a final certificate of occupancy will not be issued until after the completion of this work, and at best, the landlord should only be required to obtain a temporary certificate of occupancy.

Most tenants will attempt to negotiate inspections and warranties into a lease involving new construction. To the extent these inspections are required, the landlord should try to shorten the period of time in which the tenant can raise inspection issues. With respect to patent defects, the landlord should try to provide for the tenant to inspect the premises *before* taking possession. Once delivery occurs, the landlord should be absolved of any responsibility for patent defects. The concern is that the tenant may cause damage in the course of completing the tenant improvements or in moving into the premises. If a post-delivery inspection is required, it should be very short (30 days) and the burden should shift to the tenant to prove it did not cause the problem.

A different set of issues comes up when discussing latent defects. Again, the landlord should limit the inspection to a short period — perhaps 6 months. Better yet, the landlord should agree to assign any construction warranties to the tenant and the tenant must therefore address these concerns with the contractor or supplier. The landlord should avoid providing any warranties directly. This position should be handled carefully, however, because often a landlord will not want the tenant doing any substantive work or dealing directly with the landlord's contractors. In such a situation, the landlord should again dissuade a post-delivery inspection period, but shall agree to enforce any construction warranties against third parties.

Since the tenant has an interest in having the construction completed on time, it will often require monetary penalties if a predetermined date is missed. Often the tenant will seek a fixed dollar penalty per day, or request free rent for each day the predetermined date is missed. First of all, the landlord should resist attempts to allow *more* than 1 day of free rent for each day of delay. Next, it is important to allow for an extension of the fixed date for reasons beyond the landlord's control (the so-called "force majeure" excuses). If a tenant balks at allowing an extension for standard reasons beyond the landlord's control, the landlord should at least be excused if the cause for delay is attributable to the tenant. Has the tenant failed to deliver or approve plans on a timely basis? Has the tenant requested change orders? These items should always be valid excuses for missing fixed delivery dates.

Termination of the lease for missing the delivery date should also be avoided. If this is not possible, the

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date should be set very far in the future, as the landlord will not want this to be a remedy easily exercised. However, this negotiation tactic could backfire on the landlord and caution should be taken not to set the date too far in the future if the tenant is able to continue to obtain free rent or high penalties during the period from the missed predetermined delivery date until the termination date. The tenant may not be in a hurry to terminate and may remain satisfied with merely accumulating free rent or substantial penalties. Therefore, it is necessary to put a cap on the period of free rent or penalties. Sixty days of either is a good solution. If the landlord has not delivered possession at the end of this period, the free rent or penalties are frozen. Usually, the tenant will want the termination right to begin at this point, and the landlord will be forced to decide whether it wants to call the tenant's bluff and allow a termination right or continue to allow the penalties to accrue. One possible solution is for the landlord to allow a short window of opportunity for the tenant to terminate; failure to do so would constitute a waiver of the termination right, but also would freeze the penalties from accruing any further.

A tenant may also seek to take control of the landlord's construction activities if the tenant believes the landlord is not performing timely or in accordance with the plans and specifications. The landlord should avoid this option at all costs, unless the work in question relates to completion of minor punch list items discovered during the tenant's pre-delivery inspection.

Many retail leases provide for certain "blackout" dates during which a tenant does not have to accept delivery of the premises. This effectively pushes back the delivery date and likewise the rent commencement date. Obviously, it is critical for landlords to shorten the "window" as much as possible. Usually, a 60-day period prior to "back to school" or the winter holidays should be sufficient. Any longer period becomes excessive.

The landlord should raise the same argument for insisting on extension of the beginning of the blackout period that was raised above in connection with extensions of delivery dates to avoid penalties. If the reason for the delivery date being delayed until the blackout period is attributable to the tenant (either delaying its approval of something, failing to deliver requisite information, or requesting change orders), the tenant should not get the benefit of a further delay. The tenant should be required to accept delivery during the blackout period.

Whether the tenant caused a delay into a blackout period or not, the landlord should not, under any circumstances, be required to pay the penalties or to provide free rent through the blackout periods. The penalties and free rent should be tolled during these periods. For example, if the delivery date is supposed to be July 1, and there is a blackout period from Aug. 1 through Sept. 30, and the actual delivery date is Aug. 1, the tenant could delay possession until Oct. 1. In this situation, the tenant should receive 30 days of penalty, not 90.

Finally, the landlord should protect itself if the tenant will be performing substantial tenant improvement work. The landlord must be given the opportunity to approve plans and specifications. The landlord should also approve of the general contractor. Provisions should be added into the lease to provide for lien-free construction. If the work is substantial, perhaps the tenant should be required to establish a construction escrow. Finally, if the landlord is providing a construction allowance, the lease should provide that no amount is given to the tenant until: 1) all work is completed (or *substantially completed* as suggested in the beginning of this article), 2) sworn statements and final lien waivers are delivered from the general contractor and all subcontractors and suppliers in excess of $5000, 3) a final certificate of occupancy, if available, is delivered, and 4) the tenant has opened for business and begun paying rent.

While it is not possible to anticipate all issues that might arise during a new construction project, the above guidelines will provide much protection to a landlord in finalizing the lease and avoiding problems that would otherwise arise later.