LJN LAW JOURNAL NEWSLETTERS

Commercial Leasing LAW & STRATEGY®

An ALM Publication

Volume 26, Number 5 • November 2013

IN THE SPOTLIGHT

Buildout Provisions in Office Leases

By Anthony Casareale

A critical consideration in a tenant's office leasing decision is the aesthetic and functionality of its potential new space. For the landlord, getting from a signed lease to a tenant-in-possession paying rent is a critical transition. The signed lease should provide both parties with a clear roadmap to achieving a mutually acceptable result: a rent-paying tenant in possession of space built to its full expectation in an expeditious manner and at a cost to both landlord and tenant contemplated at the lease signing. There are several matters to be addressed in preparing this roadmap.

Who is responsible for the work necessary to prepare the premises for the tenant to move in and conduct its business?

The answer to this question determines, in almost every case, when the commencement date and, more importantly, the rent commencement date of the lease will occur. There are only three possible answers — tenant or landlord or, as in many cases, each of tenant and landlord is responsible for a portion of the work. To be absolutely clear, the work to be done by the responsible party is hiring the contractor(s) to perform the work.

continued on page 7

Heading for the Exits

Drafting Leases with a Sale of the Property in Mind

By Garland Reid and Eric Sidman

Although the volume of sales of commercial real estate properties has certainly increased since 2008 and 2009, investors and lenders continue to be relatively cautious, and minor leasing deficiencies or ambiguities can have a negative impact on — or even freeze — a sale. This article discusses select leasing issues that we have seen arise in recent investment sales transactions, and suggests drafting pointers that can be used to avoid or limit the negative impact these issues may have on the sale of a property.

Tenant Estoppels

Often dealt with at the end of a lease negotiation, when both landlord and tenant are worn out and looking forward to lease execution, tenant estoppel provisions can negatively impact a future sale of the property if not handled properly by landlord's counsel. For example, if it is true that "time kills deals," lease provisions governing the timing of a tenant's obligation to return an estoppel certificate should, if possible, not be at odds with the seller/landlord's goals, in the sale context, of a short due-diligence period for the purchaser and a quick closing.

These can be difficult goals to achieve if a major tenant has a long period of time (say, in excess of 30 days, or worse, no specified period of time at all) in which to return an executed estoppel. In that instance, including the time it takes for a seller to prepare and a purchaser to review the estoppel, the estoppel process for a given tenant could be much longer than a seller or purchaser is willing to accept. Therefore, when drafting an estoppel provision in a lease, every effort should be made by landlord's counsel to minimize the amount of time that a tenant has to return an executed estoppel to the landlord.

Ideally, the lease should state that an executed estoppel must be returned within a week to 10 days after it has been received by the tenant from the landlord, with perhaps a maximum of 20 days. If an estoppel is not returned in the

continued on page 2

In This Issue

Leases and Sales

continued from page 1

specified time period, the lease should state that the tenant is deemed to have executed the estoppel in the form submitted by the landlord, or that the landlord is designated as tenant's attorney-in-fact for purposes of executing the estoppel. While sophisticated tenants are not likely to permit such a provision (and sophisticated purchasers may not allow "deemed executed" estoppels to count toward meeting a closing condition for major tenant required estoppels), it should be included in the standard form lease. Particularly for meeting shop space tenant estoppel thresholds in purchase and sale contracts, such a provision may permit a sale, which would otherwise be held up, to go forward.

A corollary issue is how often estoppels can be requested of tenants. With investors and lenders still relatively skittish, it is not uncommon for the seller of a commercial property to have a contract (or multiple contracts) terminated before consummating a sale. If a contract termination occurred after estoppels have been circulated and possibly even returned (a not-unheard-of possibility), a seller, upon getting the property back under contract, would then most likely have to circulate a second estoppel to the tenant naming the new purchaser and updating the "facts." If a given tenant's lease contained a severely restrictive annual limit on the number of times a seller could request an estoppel, then a seller could quickly find itself in a corner (particularly if any lender involved in the sale requires its own estoppel).

Typically, only a larger or national tenant would negotiate such a limitation, and most purchasers will specifically require estoppels from such tenants and refuse to accept a seller estoppel in lieu of a tenant estoppel in such cases. As such, it is important that landlord's counsel resist, if at all possible, a tenant's attempt to limit estoppel requests to a very low annual number (say, one or two), and in any event, landlord's counsel should try to "carve out" estoppel requests in the context of the sale or financing of the property from the tenant's overall limit.

Not surprisingly, a significant estoppel issue in the context of a purchase and sale transaction is the content of the estoppel itself. Ideally for the seller/landlord, the lease will state that a tenant must return an executed estoppel in a form requested by landlord that certifies to the standard estoppel requests (*e.g.*, the term of the lease, the existence of renewal or expansion rights, the existence of any tenant allowances or inducements, the amount of rent [including percentage rent, if any, and additional rent or operating expenses], whether landlord or tenant is in default, as well as "any other matter that [landlord] reasonably requests"). The last catch-all phrase is important, because in the context of the sale of property, a purchaser or lender might request that certain non-standard information be included in an estoppel (say, regarding the tenant's solvency, or its use of hazardous materials).

A sophisticated tenant's lease will frequently: 1) allow for the delivery of a specified form estoppel; and/or 2) provide that the tenant may qualify, "to its knowledge," all or some estoppel certifications. With respect to a form estoppel, in the context of a lease negotiation with a major

continued on page 4

Garland Reid is an associate and **Eric Sidman** is a partner in the Real Estate Practice Group of Seyfarth Shaw LLP. Their practices focus on the disposition, acquisition, development, leasing and financing of commercial real estate properties. Ms. Reid can be reached in the Atlanta office at 404-881-5462 or greid@seyfarth.com. Mr. Sidman can be reached in the New York office at 212-218-5529 or esidman@seyfarth.com. The views expressed in this article are those of the authors, and not necessarily those of Seyfarth Shaw.

Commercial Leasing
LAW & STRATEGY®

Commercial Leasing Law & Strategy® (ISSN 0898-5634) is published by Law Journal Newsletters, a division of ALM.

Commercial Leasing Law & Strategy P0000-227
Periodicals Postage Pending at Philadelphia, PA
POSTMASTER: Send address changes to:
ALM
120 Broadway, New York, NY 10271

Published Monthly by:
Law Journal Newsletters
1617 JFK Boulevard, Suite 1750, Philadelphia, PA 19103
www.ljnonline.com

Commercial Real Estate Debt Restructuring

By Steve Huntley and Mark Richardson

For real estate bankruptcy law practices, there is significant opportunity in distressed real estate. Actually, the opportunity is enormous: At the end of 2012, U.S. commercial real estate debt was estimated to have reached $3.6 trillion. Approximately 10% of the total will mature each year for the next five years. Most of the $350 billion in debt coming due annually to 2017 originated in the early part of the decade. And much of that debt will not be able to be refinanced, causing a maturity default. To restructure loans experiencing maturity defaults effectively, the business, finance, and legal sectors must collaborate in a field that is as much art as it is science.

Real Estate Restructuring Teams

As law firms experiment with new approaches to improving performance for clients, they are focusing increasingly on partnering with financial restructuring experts. In our view, this increases the probability and magnitude of success for the client.

Since the financial crisis, banks had been extending many loans with the hope that asset values would recover rather than pushing for repayment and risk having to classify loans as non-performing. However, with ultra-low interest rates and lack of pressure by regulators to clear weak loans from balance sheets, banks have used this time to build loan loss reserves. With stronger balance sheets and greater regulatory scrutiny, banks can no longer continue to carry those kinds of loans on their books.

With underwater loans coming due, debtors risk not only losing their assets through foreclosure, they also jeopardize other collateral, including personal assets, when loans include cross-collateralization or personal guarantees. In these cases, banks are much more aggressive in demanding full repayment and pursuing borrowers for deficiencies when foreclosure and subsequent asset sales fail to fully cover loan balances.

Helping with the Debt

There is no single best way to assist those in distress with commercial real estate debt. Bankruptcy attorneys, together with financial restructuring advisers, have developed a comprehensive set of best practices that achieve objectives such as:

- Comprehensive analysis and strategic planning, taking into consideration the client's entire portfolio and the net benefits of every possible alternative;
- Multidisciplinary team negotiation with creditors, which in itself creates a position of strength;
- Strategies to protect the debtor's core business liabilities and minimize risk for other stakeholders;
- Reduction or elimination of personal guarantees;
- Restructuring the balance sheet to restore liquidity, positioning clients to return to financial stability;
- Debt reduction;
- Discounted payoffs; and
- Recapitalization funding to implement negotiated solutions.

In essence, best practices combine the legal expertise of bankruptcy attorneys with the financial expertise and business strategy of the financial restructuring advisers. Because of the nuances specific to each bank and loan, the partnership between a financial restructuring firm and experienced bankruptcy legal counsel is critical to maximizing the outcome for the client to achieve the highest level of financial analysis, assessment of all strategic alternatives and the most aggressive and experienced negotiation with creditors.

What the Restructuring Professional Does

The financial restructuring professional works side by side with the clients' bankruptcy attorney for interpretation of federal and state regulations, legal procedures, and the developing case law relevant in each situation. In addition, there is often the need to use legal remedies, ranging from injunctions to lawsuits. When assessing plans for Chapter 11 proceedings, the bankruptcy attorney plays a crucial role in helping to develop a plan with the highest probability of confirmation by the court. The financial restructuring adviser complements his or her legal expertise with a complete working knowledge of all proposals' non-legal components, including financial and operational aspects.

Best practices utilize a three-step approach.

The first is to understand the debtor's specific situation and overall business prospects at a granular level. To accomplish this step, the financial restructuring professional analyzes the entire portfolio of the debtor's assets and operations, not just real estate. A detailed restructuring plan is then created, encompassing the complete set of alternative scenarios that can play out in the restructuring process. The plan takes into account each reaction and counter movement of all the stakeholders. In addition, a granular understanding of the impact of each scenario on the entire client portfolio is necessary. Every scenario must be realistic and accurate. This part of the process demands the fused knowledge of a CFO-level professional working closely with legal counsel. If the business or asset can be presented as a going concern, the debtor is more likely to come out of the restructuring in better condition.

continued on page 4

Steve Huntley is a founding principal and **Mark Richardson** is a principal of Huntley, Mullaney, Spargo & Sullivan, Inc., a financial restructuring firm. They may be reached at shuntley@hmsinc.net or 925-831-3233; and mrichardson@hmsinc.net or 415-677-9627, respectively.

Restructuring

continued from page 3

The second step entails insight into the changing dynamics of capital markets and investor behavior on a national and local level for each asset class. This level of knowledge is a prerequisite for preparing lender proposals that have a realistic chance of success while at the same time garnering the maximum benefit for the client. The more market awareness, especially about emerging trends, the more persuasive the team can be in negotiations.

The third step is the bankruptcy legal analysis including review of critical decisions ranging from regulations to filing lawsuits. The laws of one district related to commercial real estate may differ significantly from those of another having a drastic effect on the strategy. For example, the team must proceed much more quickly in a state that allows non-judicial foreclosure than one where only judicial foreclosure is permitted.

Another one of the many considerations are the federal and state taxes related to restructured debt. An example of the benefits of a comprehensive team of finance, business, and legal experts is the ability to configure the situation in a way that allows the debtor to benefit from tax law and reduce the tax cost associated with the workout.

After completing this three-part process, the debtor is ready to consider one or more of several options, including:

- Discounted payoff;
- Bridging the equity gap;
- Loan modification; or
- Foreclosure or deed-in-lieu of foreclosure.

While many borrowers and virtually all bankruptcy attorneys have experience with these options, the complexity in practice and uniqueness of each borrower's portfolio and situation demand a highly specific expertise. The most common mistake made by overleveraged borrowers: trying to perform a restructuring by themselves with their bank and then bringing in legal counsel later in the process.

Like a chess game, the restructuring process is highly complex and technical. The further along in the game, the fewer alternatives that remain for the borrower. Often, a financial restructuring specialist is brought late into a situation when the borrower has already painted itself into a corner, resulting in a diminished range of alternatives and limited potential benefits.

It is critical for borrowers and bankruptcy attorneys alike to realize that the professionals inside a bank's workout group are highly specialized. They are much different from the loan officers who originated the loans. These workout specialists are much more aggressive and technically astute with respect to non-performing loans and ways to maximize the bank's recovery at the expense of the borrower and, they must presume, other lenders who may also have underwater loans with the borrower. As a result, the borrower is "playing chess" with a professional who rarely loses to a less experienced opponent.

In today's environment, to maximize the outcome for distressed debt restructuring, the owner needs to assemble the best team of experts. Seasoned, successful bankruptcy attorneys and financial restructuring advisers will bring crucial components to complement the team. The right restructuring team will have the experience to know what each lender will and won't do in various situations. The key differentiation of this experience is not only realizing that each lender differs, but knowing how they differ — that's one critical qualification to consider in selecting a restructuring firm.

Another key element is in the quality of the financial analysis and planning, taking into account the bank's perspective. The team needs a depth of background on the banking as well as the borrower's side, which is essential in bringing an understanding of the lender's needs to the strategic planning and negotiating process. This provides clients with a competitive advantage in attaining a success outcome with their lenders.

—❖—

Leases and Sales

continued from page 2

tenant, a landlord will have little choice but to start with the tenant's standard form estoppel, but from there, landlord's counsel should try to include as many additional certifications as possible, as well as ensure that any knowledge qualifiers are appropriately limited. For example, knowledge qualifiers should be limited to "subjective" matters. A tenant should be able to certify without a knowledge qualifier to the amount of its rent, the term of its lease, and whether it does or does not have renewal or expansion rights; however, and more understandably, a tenant might not want to certify, without qualification, that the landlord is not in default.

If a knowledge qualifier is inserted into a particular certification by tenant's counsel, landlord's counsel might attempt to negotiate it further; for example, a standard "to tenant's knowledge" qualifier might become "to the best of tenant's knowledge" or "to tenant's actual knowledge after due inquiry," thereby shading slightly in the seller/landlord's favor. As modified, these qualifications hold the tenant to a higher standard and allow the estoppel beneficiary a plausible argument that a tenant is estopped from raising a claim if, for example, the tenant's store or office manager had knowledge of a landlord default, but the corporate office failed to inquire regarding same and did not raise it in the estoppel. And a brief point as to the "estoppel beneficiary" — landlord's counsel should take care to draft the estoppel lease provision, or the estoppel form itself, to provide expressly that the estoppel may be relied upon by the seller/landlord, the purchaser/successor landlord, purchaser's lender, and their respective successors and

continued on page 6

How Low Can You Go?

Issues Concerning Rent Reductions

By Ira Fierstein

While most professionals are in agreement that the retail industry has recovered somewhat from the depths of the recession, there are still many retailers who are struggling to generate profits, either for their entire enterprise or for specific locations. As a result, these tenants have approached landlords to renegotiate their rent in order to lower their occupancy costs as they struggle to remain open.

Tenant Scenarios

In many instances, these tenants rely on one of the following positions to persuade the landlords to come to the table:

1. The tenant has a sales "kick-out" or "early termination" clause, and the tenant is threatening to exercise this right unless the landlord agrees to a rent concession. In a 10-year term, for example, occasionally a tenant will negotiate this in the original lease as an option that arises after the fifth lease year, if the sales during the fifth lease year do not equal or exceed some minimum threshold.
2. The lease is coming to the end of the term, and the tenant threatens not to extend the term or exercise an option to renew unless the landlord agrees to reduce the rent in the renewal option period for less than previously negotiated in the lease, or less than the rent currently being paid.
3. The tenant has other termination rights and it is threatening to exercise one of them unless the landlord reduces the rent. For example, there might be a co-tenancy breach, or exclusive use breach or right to terminate if the landlord has exercised a relocation option.
4. The tenant has no personal liability, has signed the lease in the name of a shell entity, and there is little security deposit. In this situation, the tenant may simply threaten to default or file bankruptcy.

Faced with these situations, landlords must decide between the lesser of two evils: making some concession to the existing tenant or accepting vacant space in a soft market.

Landlord Strategies

To eliminate or reduce the impact of these two evils, the landlord can attempt to limit the availability of these tenant options during the lease negotiation stage.

In the first situation, before agreeing to a "kick-out" right, the landlord should require the tenant to be fully operating during the test year, and fully stocked, staffed and fixtured. The tenant should be required to use reasonable efforts to maximize gross sales, including marketing the premises at a level that the tenant markets other stores in the area. The lease should also provide that if the tenant has achieved said sales level in *any* 12-month period prior to the test year, the termination right may not be exercised. If the tenant will not agree to this last concept, then a compromise would be that if the tenant has achieved the minimum sales threshold in any 12-month period, but not the test year, then the lease term is extended for one more year past the test year, and gross sales must be below the sales level again in the year following the original test year, in order to allow the tenant to terminate early.

If the tenant simply refuses to exercise a renewal option without a rent concession, or asks for a lower rent to extend the term, the landlord must perform adequate due diligence to determine if the tenant is really struggling in the store or is just trying to better the deal. The landlord must look at the contractual rent as compared with current market conditions and determine if there is a risk in calling the tenant's bluff. Is the renewal option rent higher than current fair market rent? Is the shopping center near capacity with other potential tenants available that will pay higher rent?

In a situation where the tenant has no right to terminate, but is threatening simply to default under the lease, the landlord must again review the tenant's financial situation and review the remedies negotiated in the lease to determine whether it is feasible for the landlord to exercise the security the landlord has if it denies the suggestion to renegotiate the business terms. Default remedies should be carefully studied. If the tenant has other stores in the same name, and those are performing well, the tenant's threats may be weakened. Can the landlord apply a security deposit or draw on a letter of credit? Is there a guaranty?

Reduction Accepted

Once the decision has been made to reduce the contractual rent, the landlord must decide on the nature of the reduction and the length of time of the reduction. Is it for a year, or the remainder of the term, or does it extend into the next renewal option? Does the landlord agree to an absolute reduction, or perhaps the reduction only serves to postpone or "defer" the amount of the reduction, and the tenant must make up the shortfall at a later date. In some situations, only additional rent (taxes and common area maintenance) is excused, while base rent remains the same as originally set forth in the lease.

In other situations, the tenant is permitted to pay only percentage rent over a $0 base, instead of a fixed minimum rent. If the tenant's base rent is reduced to a lower fixed amount, the landlord must remember similarly to reduce the breakpoint for determining percentage rent, if applicable, especially if the breakpoint was previously based on

continued on page 6

Ira Fierstein, a member of this newsletter's Board of Editors, is Co-Chair of the Leasing Practice Group and a partner in the Chicago office of Seyfarth Shaw LLP.

Rent Reduction

continued from page 5

a natural break. The landlord may also provide that once rent is lowered, if the gross sales subsequently exceed some set dollar amount, indicating that the tenant has recovered, the rent reduction is terminated, and the original rent level is reinstated.

If the landlord is forced to reduce rent, it should attempt to get some kind of trade-off for this concession. A careful review of the lease may indicate several provisions that the landlord should require be used in a re-trade. Are there co-tenancy requirements that should be deleted? Should the landlord be given an early termination right for low sales? Should expansion or renewal rights be terminated? Perhaps broad-use rights or exclusives should no longer be allowed. If the tenant is requiring rent relief because it is not doing well, it should no longer have certain rights that are typically only granted to tenants paying market rent and expected to perform well.

The landlord should also consider a right to re-market the space if the tenant is receiving a rent concession that allows it to pay below market rent. The landlord should be given the right in the future to terminate the lease, or relocate the tenant, unless the tenant is willing to reinstate the original rent.

The request for a rent concession often indicates a tenant in trouble that is at risk of not performing under the lease. Therefore, as a condition to the granting of any rent reduction, the tenant should agree that the rent relief granted by the lease amendment should only remain in effect so long as the tenant does not commit an event of default, and provided that the tenant remains open to the public, fully stocked, staffed and fixtured and that the tenant uses reasonable efforts to maximize gross sales (the same requirements the landlord should have put into the lease if there were an early termination right).

If the tenant does not satisfy any of the terms of this paragraph or otherwise defaults under the lease, the rent concession terminates. To add additional strength to this requirement, the landlord might also seek to have the tenant acknowledge that the original rent payments are retroactive to the beginning of the reduced rent period if the tenant is no longer entitled to rent relief (unless the reason for termination of the rent relief is that the tenant has achieved a sufficient sales level to no longer justify the reduction).

The tenant should also agree that if within some short time period after the effective date of the lease amendment, should it file for or be put into bankruptcy, then the lease amendment containing the rent reduction should be deemed null and void. Then the lease shall be

continued on page 8

Leases and Sales

continued from page 4

assigns. These relatively simple drafting items, if successfully raised by landlord's counsel during lease negotiations, can make the estoppel process run much more smoothly, to the benefit of the seller, during the purchase and sale transaction.

Financial Statements; Sales Reports

As part of its due diligence, a potential purchaser of commercial property will want to know the financial wherewithal of its prospective tenants, in particular any large or anchor tenants, in order to assess the property fully. Obtaining this information can be challenging if the tenants are private. However, this problem can be remedied if the applicable leases allow the seller/landlord to request financial statements of the tenants and/or guarantors, to be delivered to the landlord within a reasonable period of time (say, 20 days or less) after request from the landlord. Again, a sale can be facilitated with proper lease drafting at the front end. Similarly, particularly in purchases and sales of retail properties, prospective buyers will want to know each tenants' sales

The request for a rent concession often indicates a tenant in trouble that is at risk of not performing under the lease.

generated from the subject property (probably over a several year period). Proper lease drafting will facilitate obtaining this information.

Commencement Date Certificates

To evaluate a lease rental stream properly, a purchaser of commercial property needs to know the rent commencement date. Where rent commencement is triggered off an event (*e.g.*, substantial completion of the space) rather than a date certain, an obligation of a tenant — contained in a well-drafted lease — to execute a commencement date certificate can eliminate guesswork and uncertainty. The section of the lease addressing the commencement date should include an express agreement by the tenant to execute a commencement date certificate upon the request of the landlord, the form of which should be attached to the lease as an exhibit and should include the start and end dates of the term of the lease, as well as a rent chart.

Conclusion

All of the above tips are simple enough to address in a lease, but are often overlooked as the parties tend to negotiate more contentiously the "substantive" provisions such as prohibited uses, co-tenancy provisions, exclusive uses and termination rights; however, a focus by landlord's counsel on the above matters can significantly redound to the client's benefit when it is time to sell the asset.

—❖—

In the Spotlight

continued from page 1

Who is responsible for paying for the work necessary to prepare the premises for tenant to move in and conduct its business?

Again, only three possible answers: tenant or landlord or, as in many cases, each of tenant and landlord is responsible for a portion of the cost.

Tenant Performs Buildout

With this scenario, the tenant is hiring a general contractor to construct its space according to plans prepared by the tenant's architect. The plans and the contractor are subject to the approval of the landlord. The tenant, in this instance, accepts the premises "as is." There may be improvements in the space that will be utilized or the tenant has accepted the obligation to demolish all existing improvements before commencing its work. The tenant typically gets a cash allowance from the landlord to pay for the buildout, and a period of free rent to complete the work and move in.

This scenario puts the onus on the tenant to complete the buildout before its obligation to pay rent starts. As a result, the tenant will want to have strict time limits on the landlord's approval rights and "deemed approved" provisions in the event the landlord fails to respond within such time periods. The general contractors and major subcontractors that the tenant intends to bid the work should be pre-approved by the landlord in the lease. If possible, the tenant should have the landlord approve preliminary plans in the lease, in particular, specialty items such as staircases between floors, raised floors, etc.

The tenant should try to obtain an extension of the free rent period in the event its construction is delayed for *force majeure* events and certainly for landlord delays. If the cash allowance is large enough, the tenant should request that it be used not only for the "hard costs" of construction, but also "soft costs" (permit fees, architect/space planner fees, etc.), furniture, fixtures and equipment (such as IT cabling, etc.), with any unused allowance credited against rent. The landlord, on the other hand, will have a lease provision that details the disbursement of the cash allowance similar to disbursements of a construction loan.

Landlord Performs Base Building Work and Tenant Performs Buildout

In many instances, the space may not be in the condition to commence the tenant's work. Often, the existing improvements need to be demolished or other work, often referred to as "base building," needs to be done. This work is typically done by the landlord's contractors, at landlord's cost.

The tenant will want the lease to provide that such demolition and/or base building work is at the landlord's sole cost. Often, the lease simply says, "the premises shall be delivered with all improvements fully demolished and removed." Well represented tenants will want the lease to contain much more detail, including assurances that the premises will be asbestos free. For instance, should certain improvements such as sprinkler systems and HVAC ductwork remain?

The tenant is often facing an expiration date under its existing lease and will also want a deadline imposed on the landlord to complete its work in order to give the tenant sufficient time to complete its own work and move in. Missing the deadline would have monetary consequences to the landlord and possibly a termination right. The tenant should ask for some advance notice of completion of the landlord's work to enable it to be as ready as possible to commence its own work.

The landlord generally should be willing to provide many of these assurances and should document in a written notice to tenant the "delivery date" of the premises, which will start the clock on tenant's free rent period.

Landlord Performs Buildout

The Building Standard Workletter

When the landlord agrees to perform the buildout, it is sometimes referred to as a "turn key" lease. Typically, but not always, the "turn key" lease is for smaller space. The "turn key" lease is often used as a marketing tool to lure smaller office tenants, who do not have the internal resources, experience or inclination to plan and supervise a buildout. Typically, the building has a "building standard workletter" that the landlord has developed with its architect and can show potential tenants other tenant space built to that specification.

For the landlord, the lease should simply state that the landlord agrees to complete the work shown on an exhibit. This exhibit should contain as much detail as possible, but the execution of the lease cannot wait for full construction drawings to be attached. As a result, what is attached is a preliminary space plan layout (showing partitions, furniture layout, etc.) and a specifications list describing the improvements and finishes in some detail (sometimes referred to as the workletter).

In my experience, if not managed properly, this arrangement can lead to delays in signing the lease. Often, the business agreement reached between principals and their brokers is expressed fairly simply in a term sheet or letter of intent. A typical formulation is: "The landlord agrees to build out the premises in accordance with the building standard workletter with the finishes substantially the same as in Suite XYZ of the building."

However, as the space-planning process begins with the tenant working with the landlord's architect, requests are often made by the tenant that are beyond the so-called building standard workletter. This

continued on page 8

Anthony Casareale, a member of this newsletter's Board of Editors, is a Partner with Di Santo Bruno LLP, resident in the Miami and New York offices. He can be reached at acasareale@disantolaw.com.

In the Spotlight

continued from page 7

process will then lead to a portion of the work that will be performed by the landlord at the tenant's cost, which in turn leads to the tenant having to be sure that the cost is the lowest possible. This arrangement can lead to all sorts of problems by injecting the tenant into the landlord's bidding and contract arrangements with the contractors.

In addition, a landlord will also be pushing for lease execution when the tenant is still "tinkering" with the space plan and its requirements. I have found that in today's markets, landlords have to be patient and are without backup deals. I often recommend signing up the lease with the plan and specs as preliminarily agreed to, with the right of the tenant to request changes within a 10-20-day period, with all such changes being at the tenant's cost.

The Allowance Budget

Other leases will have the landlord agree to perform the build-out, but will allow the tenant to work with the landlord's architect in developing the plans and specs. The space-planning services are typically paid for by the landlord. The landlord, however, provides the tenant with a budget ($X per rentable square foot). The tenant is responsible for all costs above that budget.

There are several problems with this approach. As part of space planning service, the landlord will often have the architect or a contractor provide preliminary itemized pricing to the tenant to assist the tenant in making choices. However, in the end, the tenant will need to have some input in the bidding process since it is writing out the check above the allowance budget. Documenting this arrangement can be done, but the result, in reality, may not be optimum for either party. What often happens is that the landlord simply agrees to bear the risk and build out the space per the tenant's plans, or the tenant agrees to build out the space with the landlord providing a cash allowance.

Issues to Address

When a landlord agrees to perform the buildout, the issues facing the parties are cost and timing. A landlord will protect itself by providing that the tenant agree to pay for all costs associated with change orders in work requested and approved. The tenant will generally have to agree to this protection in some form, but it should consider requesting dollar credits for work that is dropped or costs saved as part of such change order request. The easiest example to think of is carpeting. If the tenant wants to select a more expensive carpet after the lease is signed, it should be given a dollar credit for the initial carpet selected that was part of the budget.

As for timing, the tenant will certainly want the lease to have a time deadline for completion of the landlord's work, and subject the landlord to monetary penalties for missing the deadline. The size of these penalties is often linked to holdover rent the tenant may face in under its existing lease. The tenant will also want a termination right if the build-out is not done by a later outside date.

Most landlords will agree to these provisions with certain caveats. First, the dates selected will have some period of time that serves as a "cushion" — typically, 30-60 days for monetary penalties and longer before a termination right is triggered. Second, the dates agreed to will be subject to extension for "tenant delays." This typically covers delays caused by a tenant's failure to respond to a request for approval in the time period required by the lease, or by delays caused by a change order in the work requested by the tenant. Third, the dates agreed to will be subject to extension in the event of a "*force majeure*" event, which should include labor strife and other causes beyond landlord's reasonable control.

Conclusion

In the end, the objective is to get a lease signed expeditiously that clearly reflects the objectives of the parties. The work for leasing counsel is to recognize the risks inherent in the build-out approach decided upon at an early stage for BOTH parties, and then negotiate and draft a lease that creates a roadmap for dealing with the risks over the three-to-nine-month build-out period after the lease is signed.

—❖—

Rent Reduction

continued from page 6

reinstated to its original terms and be deemed in full force and effect, and the landlord can file a claim for amounts due under the original lease as if the amendment had never existed.

Conclusion

While landlords should be careful to limit the circumstances in which they agree to rent reductions, doing so can often be turned into positive situations. In addition to keeping tenants in place, which tenants otherwise might terminate their leases, landlords can modify other lease provisions to be more favorable to them, and in so doing, soften the negative aspects of the concessions and come away with stronger shopping centers.

—❖—