



Allocating Construction Obligations in Leases

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By Ira Fierstein

One of the biggest areas of conflict after a lease is signed is the allocation of construction responsibility between the landlord and the tenant, but many of these problems are easily avoided by careful drafting and use of terminology at both the letter of intent and lease negotiation phases. Often, especially in the letter of intent, parties use terms that each thinks is perfectly clear, but actually mean different things to each of them. Below are some suggestions for how to handle these issues effectively.

The construction obligations of a landlord to its tenant can vary significantly, depending on what a tenant needs, how much a landlord is willing to contribute, and which party is going to control the various construction elements. At one end of the spectrum, the parties enter into a ground lease, and the tenant is responsible for constructing its own building. In this scenario, the landlord's obligations are limited to delivering a pad site to the tenant and completing the common areas of the center. At the other end of the scale is the "turn-key" project, where the landlord essentially completes all construction activities from soup to nuts, including the building and all, or almost all, of the tenant finish. The tenant simply takes the keys, installs its fixtures, stocks the store, and moves in.

Cold Dark Shell

In between the two extremes, the landlord and tenant share construction activities. In a "cold dark shell" or "raw shell" situation, the landlord will provide the building shell, including all foundation and structural work, the roof and all concrete exterior walls, and interior slab flooring. In addition, the landlord makes available water, sewer, and other utility lines to the tenant's space. The tenant is responsible for installing its own floor covering and its HVAC system and for connecting its plumbing, electricity, and other utilities to the tenant's fixtures. Usually, the landlord will also require the tenant to reimburse the landlord for sewer connection fees to the extent prepaid by the landlord. In addition, the tenant pays all required impact and utility fees. However, the cost of installing utility meters for the premises can be allocated to either party.

Vanilla Box

In a "vanilla" or "white" box delivery, the landlord does all of the above work that it would do for a raw shell, but also performs some of the items the tenant would otherwise be obligated to do. The landlord will prepare the interior finish of existing exterior walls and will install insulation. It will construct demising partitions and washrooms. A storefront will be provided, based upon plans agreed to between the parties. HVAC units will be installed and ducted through the roof. Generally, a standard fire sprinkler system and electrical panels will be provided. The tenant will arrange for its own fire alarm (unless there is a centralized system), and will complete the balance of its tenant improvements.

Establishing Guidelines

Regardless of which level of construction build-out the parties agree upon, the lease should establish certain guidelines for the work the tenant will perform. Obviously, the closer the lease is to a "turn-key" situation, the less important these requirements will be. To begin with, the landlord should specify that all work not required to be performed by the landlord will be performed by the tenant. As a general requirement, the lease should specify that all design and construction work must be approved by the landlord *and* comply with all applicable statutes, ordinances, rules, regulations, and codes of all applicable jurisdictions. Thus, the landlord's approval does not allow the tenant to begin its build-out until it is approved by the municipality and all permits and licenses have been obtained. All fees must be paid by the tenant, and the tenant should be required to obtain a Certificate of Occupancy prior to its opening.

It is important to negotiate a tight time frame for submittal of preliminary and final plans and specifications of the tenant and to require the tenant to use best efforts or all due diligence to obtain necessary approvals. Failure to comply with these time frames should constitute a default by the tenant under the lease. The tenant may also seek to impose time frames on the landlord's approval of the tenant's plans or to negotiate a termination right if the parties cannot agree on the tenant's plans. The landlord should resist a termination right or at least only permit it if the tenant's plans comply with all applicable laws (including ADA), are compatible with the rest of the shopping center, will not cost the landlord any additional time or money in connection with the

landlord's construction activities, and are consistent with the tenant's standard build-out. Often, the landlord will retain the right to obtain the tenant's permits on behalf of the tenant, at the tenant's expense, should the tenant be unable to do so or fail to do so on a timely basis.

The tenant should agree to indemnify the landlord and hold the landlord harmless from and against all claims, damages, costs, and expenses arising out of or in connection with the performance of work by the tenant. The tenant should also be required to cause its contractors to make the same indemnification.

Depending upon the level of construction the tenant is required to perform, the tenant will often be given a construction allowance. While the tenant will want periodic payments linked to progress of its work, the landlord should resist in all but the ground lease situation. Rather, the landlord should agree to pay the allowance after fulfillment of the following requirements:

- a) Completion of the tenant's work in accordance with certain specified requirements, in a manner satisfactory to the landlord's architect;
- b) Presentation to the landlord of the following: 1) A general contractor's executed and notarized sworn statement and final waiver of lien/affidavit listing all subcontractors and material suppliers and the amounts they were paid for work and materials supplied for the premises; 2) Executed and notarized final waiver of lien/affidavit from any subcontractors and material suppliers; 3) Satisfactory Waivers/affidavits;
- c) Presentation to the landlord of a Certificate of Occupancy;
- d) Opening of the tenant's store to the general public for business, fully staffed, stocked, and fixtured, and payment to the landlord of the first monthly installment of rent;
- e) No defaults under the terms and conditions of the lease.

If the lease terminates for any reason prior to its stated expiration date (including, but not limited to, on account of a tenant default), the tenant should reimburse the landlord for the unamortized amount of the construction allowance (based on a straight-line amortization).

Several other lease provisions will be affected by the division of construction obligations between the landlord and the tenant. If the tenant is constructing its own building (which is the case in a ground lease), the tenant will be required to perform all maintenance, repair, and replacement obligations, not only with respect to interior finish, but also all structural components of the building, including the roof. The tenant will be required to insure its own building and may, therefore, attempt to limit its contribution to the shopping center insurance costs. The landlord should insist that the tenant still contribute to the shopping center liability insurance and any casualty insurance unrelated to other specific tenants' spaces.

In the event of any casualty, the tenant (in a ground lease situation), should be required to rebuild regardless of whether the insurance proceeds are adequate, although the landlord will agree to allow the tenant to terminate in the last year or two of the lease term, provided the tenant razes the building and restores the landscaping. In all other situations, the tenant should be required to restore its interior finish in a timely manner. On a related note, the tenant of a ground lease should not receive any abatement of rent during the reconstruction period, it being understood that rent is absolute to the landlord. The tenant can obtain business interruption insurance to protect itself in this situation.

Conclusion

Whether negotiating a ground lease or a build-to-suit lease, the parties need to comprehend their construction obligations fully during the negotiation of the letter of intent or term sheet so that each party has an understanding of what is expected of it before formal lease negotiations begin. Once these obligations are established, the rights and obligations under the lease will be easier to draft and negotiate.

Ira Fierstein, a member of this newsletter's Board of Editors and a partner in the Chicago office of Seyfarth Shaw LLP, has negotiated "vanilla box," build-to-suit, and ground leases totaling in excess of 10 million square feet of space. He has represented national developers in the assemblage and acquisition of multi-owner properties for development of shopping centers and has resolved complex earn-out and master leasing issues.