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Working With Work Letters

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The initial construction of a tenant's space has the potential for causing considerable friction between a landlord and tenant, and this can set the tone for the landlord-tenant relationship throughout the lease term. This article is intended to identify many of the issues a tenant should consider when negotiating a work letter. A landlord may also use this article in order to anticipate potential issues when negotiating a lease with an informed tenant. Accordingly, matters for consideration by the parties are as follows:

- ***Allocation between Landlord and Tenant of Responsibility for the Completion of Improvements***. If the tenant elects to have the landlord complete the improvements, the tenant should expect to pay a higher price for such improvements. However, if the tenant undertakes responsibility for the completion of the work, it should also anticipate the assumption of liability for delays or other similar surprises. The tenant performing its own work should also anticipate that its rent commencement date will start on a specified date regardless of whether or not all the tenant's work has been completed. However, in those situations where the landlord undertakes the work, rent does not usually commence until after the landlord's substantial completion of the improvements.

- ***Determining the Value of the Landlord's Building Standard Improvements***. Early in the process, the tenant should determine the value of the landlord's improvements. Knowing this value will be helpful in comparing multiple potential lease opportunities.

- ***Phasing of Rent to Reflect Phasing of Disbursement of Tenant Allowance***. Often, landlords calculate rents on the assumption that all or almost all of the tenant allowance dollars will have been drawn down on the day that rent commences. In a project involving an extended phasing, such as an in-place renovation, the tenant should seek to provide that rents be structured to closely track not only the completion of the improvements, but also the landlord's disbursement of the tenant allowance dollars.

- ***Protecting the Tenant's Right to Receive Its Allowance***. Early in the process, the tenant should consider its improvement allowances as they may be affected by a subordination, non-disturbance and attornment agreement (SNDA). The SNDA may be left for the later portion of the lease negotiations and, consequently, the tenant may find that late in the process the landlord's

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lender will be reluctant to fund the full tenant allowance in the event the landlord defaults under its loan. While a lender's standard response may be that any unpaid allowances should be sought from the landlord after the lender has taken over the project, the reservation by the tenant of recourse against the landlord may be worthless, especially if the lease contains the customary provisions limiting the tenant's rights against the landlord to the landlord's interest in the leased premises.

- ***Financial Assurances***. Just as the landlord may seek security for the tenant's performance of its obligations, so too may the tenant seek financial assurances that the landlord will be able to pay the tenant the allowances required by the lease. Escrows or letters of credit have been established to provide this level of comfort to the tenant, but care should be taken to make sure that the escrow, if established, is not subject to offset or other attachment by the landlord's lender or other creditors.

- ***Restrictions on Use of Allowance***. A landlord might take the position that, with few exceptions, the entire allowance must be used for so-called "hard costs," thereby restricting the amount of the allowance that may be used for items such as the tenant's architectural fees, permit fees, specialized installations, telephone switch, cabling, moveable furniture, artwork or possibly free rent. The tenant should be aware that the rent it is to pay usually anticipates that the full allowance will have been made available to the tenant and, therefore, the tenant should make sure that the entire allowance will be used or otherwise applied for its benefit.

- ***Tracking the Landlord's Obligation to Disburse the Allowance with the Tenant's Obligations to Third Parties***. The conditions of any payment of the tenant allowance, such as required lien certificates, retentions, copies of subcontracts and the like, need to track the tenant's agreements with third parties. Failure to do so may require the tenant to front all or a considerable portion of the construction costs until the allowance is released from the landlord to the tenant.

- ***Relationship of Tenant Allowance to the Tenant's Security Deposit***. If it defaults on the lease, the tenant should anticipate the landlord will seek to recapture any unamortized portions of the improvement allowance paid to the tenant, and that the landlord may seek to collateralize such contingent liability by the use of a security deposit. If such liability is collateralized by a letter of credit, cash deposit or guaranty, the amount of such surety should decrease over the lease term, as the lease payments theoretically, if not in fact, should amortize the repayment of the tenant allowance to the landlord.

- ***Restoration Obligations***. Many leases provide that unless the landlord specifically agrees otherwise, any alterations (which may include the initial alterations covered by the tenant allowance) that the tenant makes to the premises are to be removed by the tenant at the end of the lease term, thereby imposing a demolition obligation on the tenant. Where the tenant's improvements are not atypical for the leased space, they should not be subject to mandatory removal by the tenant.

- ***Coordination with Landlord's Other Work***. If a tenant is building out its space at the same time the landlord is undertaking other work in the building, the tenant and the landlord should provide a mechanism for the seamless coordination of their joint construction efforts, especially if each has

separate contractors. In those instances where the tenant hires the landlord's contractor, the work letter should provide that the landlord's contractor will provide the tenant with any preferential pricing it provides to the landlord for improvements being undertaken by the landlord. This approach can offer a significant savings to the tenant and avoids the situation where the landlord's contractor low bids the landlord's base building work and seeks to make its profit on tenant improvements. This approach is especially important where the work letter requires that the tenant use the landlord's contractor for the construction of the tenant's improvements.

- ***Provision for Undiscovered Conditions***. Tenants often lease space in "as is" condition (subject to the completion of specific improvements by the landlord), and it is usually impossible for the tenant or its consultants to fully analyze the premises' existing condition prior to the time the construction process begins. Though the landlord may have a legitimate right to request that the tenant accept the premises in "as is" condition, the parties should consider how to treat conditions that are not reasonably ascertainable by the tenant through an appropriate inspection. For example, the tenant might take the position that the landlord is obligated to remedy (at its own cost) any existing code violations, undiscovered structural defects or any other conditions that are found in the tenant's space that would not exist in a building renovated or otherwise improved within a five-year period prior to the lease.

- ***Establishment of Multiple Benchmark Dates***. It is not unusual for a tenant to seek to provide in its lease a date by which work to be undertaken by the landlord needs to be completed. If such work is not completed by the specified date, the tenant may seek to reserve a contractual right of termination or a claim against the landlord for monetary damages. Although the benchmark is often a single date, the tenant should consider several benchmark dates so that if, early in the process, it becomes obvious that the landlord will not be able to meet the ultimate deadline, the tenant is not required to wait an extended period of time to exercise its remedies. Benchmarks might include dates upon which construction commences, foundations are completed, the building structure reaches ground level, and the date on which the building is topped out and enclosed.

- ***Delays***. While sanctions other than termination are often imposed upon the parties for delays they have caused, the definition of delay often leaves much to be desired. For example, if a delay occurs at one stage of the project, if the party causing the delay is later able to make up the time lost without expense or inconvenience to the other party, then there should be no delay damages or sanctions arising out of such initial delay. Often the outside date for performance by the party not causing the delay is extended on a day-for-day basis for each day of the delay, which sanction does not always reflect the actual effect of the initial delay. Additionally, if the concept of *force majeure* is involved, the parties should be careful in its definition, as some events that may be caused by acts of God might be overcome with the expenditure of monies not otherwise considered by the parties at the time the lease is signed. For example, the inability to obtain materials may require the substitution of more expensive materials, and difficulties in obtaining labor may require off-hours work or weekend shifts in order to maintain a schedule, both of which may be beyond the original contemplation of the parties and should be addressed in the definition of *force majeure* events. Additionally, even delays caused by *force majeure* should be subject to some limitation on time.

- ***Special Accommodations***. The tenant should make sure that the work letter addresses any special accommodations it or its contractor may temporarily require from the landlord in order for the tenant to effect the completion of its improvements. For example, the right to locate a dumpster next to the building, the right to construct a trash chute from an upper-level floor to a dumpster, the right to store and stage materials in an unused portion of the building, the priority use of a freight elevator and similar accommodations should be addressed by all parties in order to obtain an orderly prosecution of the improvements.

Negotiating the hazards inherent in the construction and improvement of a tenant's premises can be stressful for a tenant. However, consideration of the foregoing items should help alleviate some of the stress and surprise that might otherwise arise from the process.