COORDINATING WORK LETTERS WITH CONTRACTOR AGREEMENTS FOR TENANT IMPROVEMENTS

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As the complexity and cost of building out retail space continues to increase, the provisions in the lease relating to the construction of tenant improvements have become more critical and hotly negotiated. Whether the provisions are contained within the body of the lease or in a separate work letter, there are traps for the unwary, which can cause a client to incur additional expense or devastating delays in opening a new business or location. The issues surrounding construction have been complicated by the economic uncertainty of recent years, which has often jeopardized not only the ability of the Landlord and Tenant to perform their respective obligations, but also the ability of contractors to complete the work and pay their subcontractors.

This article highlights some of the risks inherent in construction projects and how Landlords and Tenants can properly identify, manage and assign those risks.

I. WHO IS GOING TO PERFORM THE WORK?

There are three basic alternatives: (i) Landlord performs all of the work (sometimes referred to as turn-key), (ii) Tenant performs all of the work (see discussion of base building vs. tenant improvement below), or (iii) some sharing of responsibility for the build-out. At the risk of sounding repetitive and Trinitarian, there are three core concerns which drive the decision as to who will perform the work: (1) controlling the work and selection of the contractors, (2) managing the risk of timely completion in accordance with the drawings, plans and specifications, and (3) safeguarding the payment process.

A. Control

A Landlord's desire to control the work and the selection of the contractors is natural in light of its need to protect its asset and maintain the value of its buildings. Of special importance is the need to protect the building systems, and ensure that existing Tenants are not adversely affected.

Conversely, Tenant's have very important reasons to maintain control of the build-out. For retail Tenants, (not unlike the self-help/self-improvement publishing industry) branding is the name of the game. Once built out, the space must precisely meet the current corporate image. Tenants will know contractors who have satisfactorily built out spaces in other locations and will naturally want to utilize their experience and expertise.

1. Turnkey

The single most important decision in any construction process is the selection of the architect and contractor[s]. A Landlord

may decide that all work at a project must be performed by a specific contractor and designed by a specific architect. In those cases, the Landlord will take a turnkey approach and enter directly into the contract with the builder. This necessarily places the Landlord at risk in the event of cost overruns or late project delivery. While a Tenant may be happy for the Landlord to take on these risks, the Tenant will want to retain certain rights of approval over the design and the selection of contractor[s]. In addition, the Tenant must have adequate remedies in the event of defective work or late delivery.

The construction contract typically defines the contractor's work by stating that "the Contractor shall fully execute the Work (a defined term) described in the Contract Documents (also a defined term)." In addition to the actual contract, general and special conditions of the contract, and other related conditions and exhibits, the Contract Documents will also include a list of the drawings, plans and specifications (the "Plans") prepared by the architect and other appropriate design professionals. The contractor is only obligated to build what is in the Plans and nothing further. If it is not in the Plans, the contractor is not obligated to build it.

In order to prove contractor liability for breach of contract with respect to defective work, the Tenant must prove that the finished work differs from the Plans.

If the finished product is unacceptable despite the contractor's full compliance with the Plans, the Tenant may have recourse against the architect. However, in order to recover from the architect, the Tenant must prove that the architect breached the standard of care for architects on similar projects in the same geographical area.

The contractor must also comply with the schedule requirements of the construction contract. It is imperative that the parties state that "time is of the essence of the agreement" and that the contract provide an unequivocal date for substantial completion. Substantial completion is typically the date by which the project may be used by the Tenant for its intended purpose. In all retail, office, or public use improvements, this should always expressly include, at a minimum, securing all permanent certificates of occupancy.

In addition to establishing a firm completion date or dates, it is equally important to establish the date of commencement of the work. It is not uncommon for a contractor to insist that the commencement date, and thus the start of the clock for completion, shall not be before the building permits are issued.

A further complicating fact with tenant improvements is the issue of privity. Typically, the only parties with the right to sue under a contract are parties who are in direct contractual privity with one another. If the Landlord holds the contract with the builder, the Tenant should be named as an express third-party beneficiary to remove any doubt as to the Tenant's right to sue for breach of contract. Further, the Tenant should also be named as an obligee under any applicable performance bond and, if possible, an additional insured under the contractor's general liability policy.

2. <u>Landlord work and Tenant work</u>

For various reasons the parties may elect to have Tenant select the designer and the general contractor, but Landlords may select certain trades, i.e., mechanical or electrical in order to protect the base building systems.

The primary concern with having multiple general contractors on any project is that they may interfere with each other's work and scheduling. The general contractor is the party contractually obligated to the Landlord or Tenant to complete all work under their contract within the specified time. They do not owe contractual obligations to others unless they are designated third-party beneficiaries. There is finite space on any project and multiple general contractors tend to get in each other's way. Interference by another general contractor, similar to other outside interferences such as design errors, extreme weather conditions, or force majeure, will excuse delay in completing the work. When there are multiple general contractors, if the Tenant's contractor is late with completing the improvements, rest assured they will blame the Landlord's contractor for interference. Moreover, unless contractually prohibited, a contractor may recover its own damages for delay, which can radically increase the losses to the Tenant or Landlord due to late delivery of the project.

These provisions must be precise since the coordination of scheduled work could lead to either Landlord's contractor or Tenant's contractor being delayed while the other is completing its work.

3. <u>Tenant Build-out</u>

In certain instances, the parties may elect to have the Tenant be solely responsible for the build-out. This election eliminates concerns with regard to scheduling issues and places the risk of completion squarely on the Tenant except in narrow circumstances. A Landlord will typically attempt to protect the value of its building by (i) maintaining strict approval rights over the design, (ii) requiring that Tenant use a contractor and certain subs from a

preapproved list, and/or (ii) having a construction manager oversee the work on behalf of the Landlord often at Tenant's expense.

The Landlord may engage the services of a construction manager to assist with coordinating the improvements.

B. Risk of Completion

A lease is basically a definition of premises to be leased at a specified price for a period of time, with 50 to 60 pages attached to address war stories. The work letter and its provisions affect all three of these core elements. The completion of the build-out of the premises will often trigger the commencement of the term and consequently the rental obligations. In addition, the differentiation between base building and tenant improvements will crystallize the definition of the space actually being leased.

1. Permits

While the parties can schedule out most aspects of the construction process with set deadlines and processes including approval of contractors, design and construction (the last of which is often aspirational), the permitting process is dependent on the control of the local jurisdiction. In drafting the timeframes for construction, it is essential that counsel fully investigate the vagaries of permitting in the local jurisdiction and make certain the client is aware of the very real possibilities of delay. For Tenant's counsel, this is especially true since your client may not have applied for permits in the jurisdiction previously.

Securing the permits is a multi-headed problem. First, no permits will issue until the Plans are complete and satisfactory to the local building authority.

Some municipalities and counties are more stringent than others when it comes to permitting. In some locations, the initial permit is all that is needed. In others, every change to the drawings will trigger the need for additional approval and permitting from the local authorities.

2. Substantial Completion

When the parties agree that Landlord will perform the build-out, the commencement date or the rental commencement date is often defined as the later of a specified date and substantial completion of the premises While this is a seemingly simple definition, it does lead to the question of what is substantial completion. One possible definition is the following:
"substantial completion shall mean that all of the tenant improvements have been completed in accordance with the

Construction Documents, other than punch list items and other minor defects."

From a Tenant's perspective there is one glaring omission, a built-out premises is useless to the Tenant until a certificate of occupancy is obtained.

The phrase, "in accordance with construction documents" is critical but also the crux of most construction litigation as each party determines who is responsible for a defect. A construction project is an ever evolving process with multiple layers of interested parties making decisions daily as to how to address various issues which arise.

The language, "other than punch list items and minor defects", can raise almost as many questions and problems as determining substantial completion itself. Is a problem with the store front a minor defect or is it significant enough in light of the corporate image that Tenant will refuse to open (read refuse to pay rent) until it is cured? While the issue will most likely not be addressed in the definition of substantial completion, the parties should determine a timeline for completion of the closeout items.

It is always best for the Tenant or Landlord to require permanent certificates of occupancy. Substantial completion should require a final certificate of occupancy. Failure to deliver the project, including the permanent certificates of occupancy, by the substantial completion date, may result in the contractor's liability to the Tenant or Landlord for the period of delay. These damages may be liquidated as established in the contract, or actual, as proven at trial.

Final completion occurs when all punch list items are completed and all contractually required documents (i.e., executed final unconditional lien waivers, as-built drawings, and the contractor's final affidavit) have been furnished. It is a good practice to include a separate damages provision for failure to timely achieve final completion. In addition, the Landlord or Tenant should always reserve the right to supplement an underperforming contractor at the contractor's expense.

3. <u>Landlord Delay vs. Tenant Delay</u>

Since the date of substantial completion is such a significant economic factor in the lease (please see remedies below), each party will need to protect themselves from delays caused by the other party. For these reasons, Landlords will often revise the commencement language to read, "the [later] of (i) January 1, 2010 and (ii) substantial completion or that date upon which

substantial completion would have occurred but for Tenant delays."

Similarly, Tenants will desire to protect themselves from a Landlord delay when a hard commencement date is set by revising the language so that it reads: "the [earlier] of (i) January 1, 2011 and (ii) substantial completion of the premises" to add, "notwithstanding the foregoing the commencement date shall be extended by one day for each day of delay caused by a Landlord delay." Tenants are most concerned with delays caused by a Landlord's failure to (i) approve plans, (ii) complete Landlord's work in order to allow scheduling of Tenant's work, and (iii) execute necessary permitting or occupancy applications.

Whether addressing Tenant delays or Landlord delays, a drafter should be concerned with how to determine whether a delay in response actually caused a delay in completion.

Typically, the contract should limit the contractor's right to receive an extension of time to only those events that are caused in whole or in part by the Tenant and have an impact on critical activities, i.e., those activities that, if delayed, will extend the overall completion of the work. If the event is not the fault of either party to the contract, i.e., Force Majeure, weather delay, outside forces such as labor strife, the contractor should receive an extension of time only. If the event is the fault of the Landlord or Tenant, i.e., incomplete design, slow decisions on interior finishes, interference, the contractor will likely argue that the contract should permit recovery of additional time and money. A contract clause that expressly forbids recovery of money for Tenant or Landlord caused delay is a "no damages for delay" clause. Some states prohibit "no damages for delay" clauses as against public policy.

C. Method of Payment

1. Landlord Controls The Work

When the Landlord performs the work on a turnkey basis there are no issues with regard to allocating costs or establishing timelines and criteria for the payment of same. With turnkey construction, Landlord and Tenant will agree upon a design and scope of work and Landlord will be responsible for constructing the improvements pursuant to the plans and specifications at Landlord's cost. However, the work letter will need to address the possibility of changes to the plans and specifications both with regard to approval rights and the responsibility of each party for payment of the costs, arising from change orders. Typically, the Tenant would be

responsible for any costs created by a change from the approved plans.

A change order typically results only when the parties agree to all terms of the change including scope of work, price and time. Neither side will want to execute a change order without agreement on all three issues. Once agreed to, the change order becomes an integral part of the contract and the scope of work, completion dates, and price are changed accordingly.

In addition, the Tenant should be concerned that disagreements over the price or time extension for a change in the work will delay completion.

When Landlord is responsible for building out the tenant improvements but the work is being completed at the Tenant's expense subject to a tenant improvement allowance, determining the scope of work and the budget for said work is of paramount importance. The parties will need to determine whether the tenant improvement allowance is sufficient to cover the cost of the full build-out. If it is determined that the allowance is insufficient the timing for the payment of the excess costs by Tenant must be defined.

2. <u>Tenant to Control the Work</u>

When the Tenant controls the work by directly entering into the construction contract for the build-out and is responsible for the payment there are almost no issues with regard to methods of payment unless a Landlord were to require a change after execution of the contractor agreement which is fairly unlikely. However, when Landlord is providing a tenant improvements allowance to Tenant for the build-out, the timing and method of disbursement of the allowance and of any excess costs is very important and potentially very contentious. Tenants must be very careful to ensure that it will have access to the allowance as the draws become due under the contractor's agreement.

Just as we discussed above, when the allowance is not sufficient to cover the full cost of the build out, the parties will need to decide whose money will be utilized first. Landlords will desire for the Tenant to pay the excess costs first to ensure completion and to delay payment of the allowance. Conversely, Tenant will desire to expend the allowance before utilizing its own funds.

The work letter will also establish the process and requirements for disbursement of the allowance. A schedule of draws should be set forth which provides for payment at specific benchmarks and typically a retainage amount.

In addition to the schedule for disbursement of the allowance, Landlords will impose specific criteria for disbursement. The criteria will typically include some or all of the following: (i) request for payment, (ii) lien waivers (partial or full), (iii) certificate of % completion, if applicable, (iv) evidence of Tenant contribution, if required, (v) certificate of occupancy (final payment), (vi) estimated cost to completion (if % completion), and (vii) as-built plans (final payment). This list contains several traps for the unwary which can delay disbursement. The requirement to obtain lien waivers while simple in concept can be very difficult to fulfill if they must be obtained from all subcontractors. Obtaining the certificate of percentage completion adds another interested party in the architect who may delay the process and will want to be re-numerated for the contract administration function. As-built plans can be expensive and may be the cause of additional delays. One suggestion for Tenants is to change this to final construction documents which will have been prepared before completion.

At a minimum, the Landlord or Tenant must strive for a lien free project. This will require the contractor to submit executed lien waivers for itself and its subcontractors and suppliers, showing that the payment from the most recent pay application has been received and lien claims through that payment waived

II. SECURING PAYMENT AND PERFORMANCE

As the economy continues to stall the certainty that a Landlord will be able to actually pay the agreed upon allowance has become a very real concern. Similarly, Landlords must be much more cautious of a Tenant's ability to complete construction without liens being placed on the property as store closings and Tenant bankruptcies have become common occurrences

A. Tenant's Options To Secure Allowance

In many circumstances, a tenant's ability to build-out and open its store is completely dependent on receiving the Tenant Improvement allowance from the Landlord since the Tenant does not have the capital or the ability to raise it from other sources. While Tenants may desire to have the Landlord pay the allowances upfront to avoid this concern, there is almost no scenario where a Landlord would agree to this method of payment.

One alternative is to have the allowance placed in escrow with a third party to be disbursed based on certain milestones and requirements.

From a Landlord's perspective, placing the money in an escrow is

not appetizing because it locks up their capital prematurely. However, the escrow does provide comfort that the allowance will only be delivered to the Tenant based on work performed and assurances that the contractors have been paid.

Another, possibly more remote option, is to require the Landlord to provide a letter of credit to cover the amount of the allowance in bankruptcy. A letter of credit is an obligation of the financial institution to the Tenant rather than the obligation of the Tenant.

B. <u>Landlord's Option to Secure Performance</u>

Landlord's ability to ensure performance by Tenant is directly related to control over the disbursement of the allowance.

In order to ensure the build out is in balance, a Landlord will desire to provide that a Tenant must pay any excess costs either prior to commencement or at the time of each draw.
In addition, tying the payment of the allowance to percentage of completion rather than costs incurred has two benefits. First, it helps ensure that the amounts of money spent, and the amount remaining, are in balance with the level of completion. Second, implementation essentially requires that the parties employ a competent professional, typically the architect, to review the pay applications against the level of completion of the work.

Landlords will also desire to control the documents which need to be provided prior to disbursement. The most significant of these requirements is the providing of liens waivers.

While certainly not of the least importance, it seems appropriate to discuss retainage last. Retainage is a contractually allowed amount of money held back from payments otherwise due and owing to the contractor. By withholding sufficient retainage, a Landlord has some comfort that enough money remains to complete the project if the contractor defaults, and a hammer to ensure that punch list items are completed.

In addition to negotiating the percentage of the retainage, the parties must also determine how it will be withheld. There are two basic options: (i) the retainage is held until final completion with otherwise full disbursement of the allowance; and, (ii) the retainage is deducted as a percentage from each disbursement. Simply put, Tenants prefer the first option and Landlords prefer the second.

C. <u>Securing Contractor's Performance</u>

As alluded to earlier in these materials, the most important safeguard is to select a quality design team and contractor. The next step to securing performance is to draft a solid contract that clearly defines the parties' rights and obligations in the event of non-

performance. In the end, however, the Landlord or Tenant must have viable options in the event of non-performance.

At a minimum, they should have the right to supplement a defaulting general contractor with additional laborers or subcontractors. This supplementation should be at the contractor's expense upon notice and opportunity to cure. Further, the contract should specify that the Landlord or Tenant have a right to recover either liquidated or actual damages for late completion. Liquidated damages are a sum certain paid for each day the project is late

As an additional safeguard, the Landlord or Tenant may require the contractor to furnish a performance bond. The contractor normally procures the bond and the Tenant or Landlord, depending on who is defined as the obligee under the bond, pays the premium.

The Tenant may have other resources to encourage contractor performance, such as the retainage discussed above and the right to withhold payment on pay applications until the architect certifies that sufficient work has been completed to justify the requested amount. However, any refusal to pay must be carefully considered. If the contractor is, in fact, contractually entitled to payment, the Tenant will likely be in breach of the contract for failure to pay. This will result in work stoppage and liens as the general contractor is unable to pay its subcontractors. Not only do liens raise the possibility of additional costs to the Landlord and Tenant, but they may also result in a default under any loan documents. This naturally can have severe consequences on the project.