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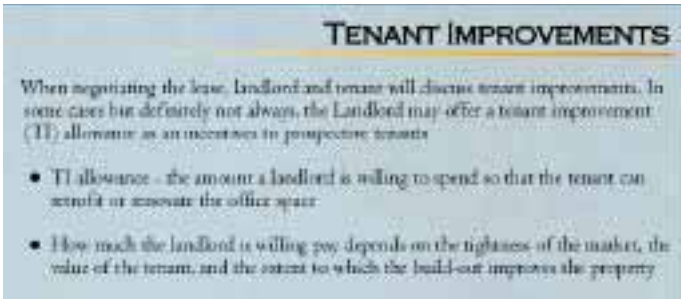
Does Your Work Letter Work For You?

Tips to mitigate risk in commercial lease work letters

A "work letter" contains the landlord and tenant's agreement regarding the initial construction and improvements to leased premises. Key elements are which party will be responsible for actually constructing the work and how will the parties allocate the cost of the work. Common work letter structures include:

- The landlord constructs the work on a "turnkey" basis, meaning that the landlord pays all costs of the work.
- The landlord constructs the work and provides pre-set tenant allowance to apply to the cost of the work, and the tenant pays all costs of the work in excess of the allowance.
- The tenant constructs the work and landlord provides an allowance, with the tenant paying all costs in excess of the allowance

Work letters are often overlooked or considered an afterthought since they typically appear deep in the lease document, often as an exhibit or appendix. However, there are myriad risks to both landlord and tenant in the initial construction process and accordingly, the work letter merits careful attention to detail. Here I will discuss some of the common risks to each party and suggest ways to lessen those risks within the work letter itself.



TENANT IMPROVEMENTS

When negotiating the lease, landlord and tenant will discuss tenant improvements. In some cases but definitely not always, the Landlord may offer a tenant improvement (TI) allowance as an incentives to prospective tenants

- TI allowance - the amount a landlord is willing to spend so that the tenant can retrofit or renovate the office space
- How much the landlord is willing pay depends on the tightness of the market, the value of the tenant, and the extent to which the build-out improves the property

Common risks posed when the **landlord** is doing the construction:

If the landlord is performing the work on a "turnkey" basis, the landlord is taking on a risk of **cost overruns**. To mitigate these risks, the parties ought to agree to a clear scope of the work and specifications (e.g., grade of carpeting and fixtures), as well as a clear definition of what is considered "building standard," since that term is often used as a reference point for specifications, but not itself fleshed out in appropriate detail. The landlord will also want to require that any changes requested by the tenant outside the pre-defined scope will be at tenant's expense.

Cost overruns also pose a risk to the tenant when the tenant is paying for the cost of the work in excess of an allowance or for change orders (as noted above). In such a case, the tenant should carefully review the landlord's budget for the work to ensure it is realistic and further negotiate for advance approval of any change that will increase the budgeted cost (since that increase will be passed to the tenant).

For both landlord and tenant, agreeing in advance on the scope and specifications of the work helps to mitigate the risk of excess costs and avoid unwelcome surprises. Ideally, the parties should attach the actual plans and a detailed list of specifications as an exhibit to the lease.

Construction delays can adversely affect both parties to a lease. For a tenant, construction delays which delay the tenant's move from its existing space into a new space could create holdover situation for the tenant in the existing location, or a delay in construction could interrupt the tenant's ongoing business. To lessen these risks to the tenant, the tenant could structure the lease so that the tenant's obligation to pay rent does not start until the work is completed, thus incentivizing the landlord to complete the work sooner. The tenant could negotiate for a rent abatement remedy for each day beyond the anticipated delivery date that the work is not completed or require that the landlord pay the tenant's holdover rent at its existing location (or some other liquidated amount) in the event of a construction delay.

For the landlord, if the lease commencement and rent commencement dates are tied to the substantial completion of the initial improvements, construction delays will cause the landlord to lose out on rental income (or cause the landlord to incur penalties as outlined above). The landlord protect itself with a force majeure provision and a "tenant delay" concept, in which the landlord is not responsible for delays caused by the tenant (and therefore, the lease would commence on the date that the work would have otherwise been completed, if not for a tenant delay). Common "tenant delays" are tenant requests to change the plans, tenant's failure to timely respond to requests for approvals and other tenant-controlled decisions in regard to the work. Incidentally, this is another reason why agreeing on the plans and scope of work in advance benefits the landlord – it cuts out the plan approval process and allows the landlord to start the permitting process more quickly, both of which can be lengthy and a common cause of delays.

The **quality of the work** when the landlord is responsible for the improvements can pose another risk to the tenant, particularly if the tenant is going to take over maintenance and repair obligations for the premises going forward. To mitigate quality issues, the tenant should require a punch list process and require the landlord to commit to repairing defects in the work, as well as require the landlord to assign all applicable warranties regarding the work to the tenant.

Common risks posed when the **tenant** is doing the construction:

When the tenant is performing the work, the landlord is apt to have concerns about the quality of the work as well as potential damage to the landlord's building.

about the quality of the work as well as potential damage to the landlord's building. To mitigate the risk that the tenant's work is sub-par, the landlord can negotiate for a work letter provision requiring the landlord's approval of the tenant's contractor, or perhaps even require the tenant to select from a list of landlord-approved contractors who are familiar with the building. Further, the landlord will wisely condition its obligation to pay the allowance on the landlord's approval of the work. To mitigate the risk of damage to the building, the lease should require, as a lease covenant, that the tenant repair any damage to the building. Then, as a condition to paying the allowance, the lease should state that the tenant must be in full compliance with the lease, thus making the obligation to repair the building a condition to getting the allowance. The landlord can also protect the building by requiring the contractor and tenant to carry insurance related to the work, which should be outlined in the work letter. Many landlords, for example, will require the tenant's contractor to carry a "builder's risk" policy while the work is being constructed in addition to general commercial liability insurance.

Construction delays can also pose a risk to the landlord if the lease commencement is tied to construction completion. In this instance, the landlord is advised to negotiate for a "drop dead" commencement date as well as a deadline for the tenant to apply the allowance as an incentive for the tenant to timely complete its construction.

On the tenant's side, there is a risk that the landlord may refuse or be unable to pay the allowance. The tenant can mitigate this risk by conducting appropriate due diligence on the landlord to ensure that the landlord will have the means to pay the allowance when the time comes. If the tenant's investigation reveals concerns, the tenant may want to request that the allowance be placed into escrow as a precaution. Another remedy for the tenant is a rent offset right in the event the landlord fails to timely pay the construction allowance.

Many tenant work letters will require the tenant to deliver interim and final lien waivers from all contractors and materialman who have provided labor and materials to the premises, as well as copies of the final as-built plants, a copy of the certificate of occupancy, if applicable, and documentation showing the actual costs of the work. If the lease requires these items, the landlord is not legally obligated to pay any of the allowance until the tenant provides them, so the tenant should familiarize itself with the completion requirements in the work letter and request the applicable documentation from its contractor throughout the construction process.

This article touches on only a few of the issues that can arise in negotiating a work letter. In sum, though, both the landlord and tenant will be better served by carefully reviewing, negotiating and drafting the work letter before signing the lease.

All 50 states are listed across the top of the Lincoln Memorial on the back of the $5 bill.

YOU NEED TO KNOW

The United States Supreme Court

The Justices

Seated (L-R): Clarence Thomas, age 68 (nominated by Pres. George H.W. Bush in 1991); ghosted image of Antonin Scalia who died at age 79 in February, 2016 (nominated by Pres. Ronald Reagan in 1986); Chief Justice John G. Roberts, age 61 (nominated by Pres. George W. Bush in 2005); Anthony M. Kennedy, age 80 (nominated by Pres. Ronald Reagan in 1988); Ruth Bader Ginsburg, age 83 (nominated by Pres. Bill Clinton in 1993); Standing (L-R): Sonia Sotomayor, age 62 (nominated by Pres. Barack Obama in 2009); Stephen G. Breyer, age 78 (nominated by Pres. Bill Clinton in 1994); Samuel A. Alito Jr., age 66 (nominated by Pres. George W. Bush in 2006); Elena Kagan, age 56 (nominated by Pres. Barack Obama in 2010)

Random Facts:

Approximately 10,000 cases are appealed to the Supreme Court every year. Of these, the Court actually hears approximately 75 – 80…. Each attorney has a maximum of 30 minutes to argue his/her case…. There are 100-150 public seats available on a first-come, first-served basis…. There are no cameras in the courtroom allowed…. Justices hold their position for life (or for as long as they choose)….The Constitution cites only two requirements to be a Supreme Court justice: 1) They must be appointed by the president and 2) they must be approved by the Senate; they don't have to be lawyers, judges, citizens or even 21. (In reality, every justice who has ever served was a lawyer first.)….The longest serving justice was William O. Douglas, who retired in November, 1975 after 36 years and six months on the bench…. George Washington appointed the most Supreme Court justices (11). Only Franklin D. Roosevelt came close, with 9 appointments…. William H. Taft was the only president to also serve as a Supreme Court justice…. John Marshall is the only justice to have ever been Secretary of State…. Justice Byron ("Whizzer") White is the only justice in the College Football Hall of Fame…. Of all one-term presidents, Taft appointed the most Supreme Court justices (6)…. Jimmy Carter is the only president to serve a full term without nominating a Supreme Court justice…. The Constitution does not establish the number of Supreme Court justices. Instead, it gives Congress the power to determine the number of justices…. In 1789, the Chief Justice's salary was $4,000, while associate justices made $3,500; in 2016, the chief justice's salary is $260,700 and associate justices receive $249,300.

Merrick Brian Garland

Merrick Brian Garland

Born in November 1952 in Chicago, Merrick Brian Garland is the Chief Judge of the United States Court of Appeals for the District of Columbia Circuit. A summa cum laude graduate (and valedictorian) of Harvard Law School, he has served on that court since 1997. On March 16, 2016, President Obama nominated Garland to fill the Supreme Court seat vacated by the death of Antonin Scalia on February 13th. The Constitution says that unless the Senate gives advice and consent Garland cannot be appointed, but it does not require the Senate to do anything in response to the nomination. Garland is, by all accounts, eminently qualified and a fine judge; the Senate's failure to take formal action may be regrettable, but that is a decision the Constitution entrusts to the political process. It would be somewhat easier for the Court to operate with nine justices than eight. But the Constitution does not require nine justices at all; at various times in history, Congress has provided for six, eight, or ten. Like lower federal courts and executive offices, the ninth seat is entirely Congress' creation and could be abolished if Congress chooses. While there may be a constitutional obligation to maintain a Supreme Court, there is no constitutional obligation to maintain nine justices nor to assure that the Court operates at maximum efficiency.