Thursday, October 24, 2024
9:15 AM – 10:15 AM

Workshop Session 9

Workletters and the Path to "Substantial Completion": If You Build It, They Will Come

Presented to

2024 ICSC+U.S. LAW
JW Marriot Orlando Grande Lakes, Florida
October 23-25, 2024

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WORKSHOP HYPOTHETICALS

Hypothetical #1

Your client, a regional Landlord, sends you a term sheet for a 35,000 sf end cap, ground floor space within a 175,0000 sf, (grocery anchored) suburban outdoor center that was constructed in 1986 ("***Regional Landlord***"). The prospective Tenant is a regional sports equipment retailer that is in the midst of launching a new experiential concept that prioritizes two growth industries – golf and pickleball ("***Sports Experience Tenant***"). The location will feature a 12,000 sf traditional retail store that occupies the front of the premises along with a 3,000 sf sit-down cafe that offers counter-service beverages, sandwiches and desserts that will be licensed to and operated by a national fast casual brand that has an exclusive license with Sports Experience Tenant to partner in the development of these locations. The rear of the premises will be split into a 15,000 sf pickleball court area and a 5,000 sf golf simulator area.

Sports Experience Tenant has agreed to a modified "AS IS" delivery, subject to the following conditions: 1) the existing concrete floor slab may not be delivered with more than ¼ inch elevation variance in the pickleball and golf simulation areas; 2) the roof must be in water-tight condition and capable of supporting Tenant's rooftop HVAC installation; (3) Tenant's minimum electrical and water/sewer capacities are listed with technical specifications that must be in place on the delivery date; (4) the Landlord agrees to resurface or repave the parking field directly in front of the premises and the loading area in the rear of the Premises (5) and the Landlord agrees to obtain all necessary third-party approvals, permits and consents that may be needed for the Tenant to perform Tenant's work, open and operate for the permitted uses (other than Tenant's building permit and certificate of occupancy). In addition to these delivery obligations, Regional Landlord is providing a $1,250,000 ($35.71 per square foot) construction allowance.

You know this center well. This space, which was occupied for over 20 years by a now bankrupt home decor, bed and bathroom retailer, has remained vacant for over four (4) years. The center has a vacant pad site and several other vacant in-line spaces proximate to the space. Your firm handles Regional Landlord's leasing and financing work, and you know that after much difficulty, Regional Landlord recently refinanced the debt on this outdoor center and has access to a revolving credit line for capital improvements and tenant allowances, subject to its lender's consent in each instance.

Hypothetical #2

It's a busy week, the following day, your newest client, a local restaurant group ("***Rotterdam Pub***") sends you a term sheet for your first project with the group for their second restaurant location. The term sheet is for a vacant, undeveloped, pad-site at a well-known power center, formerly occupied by a dry cleaner, which will be developed as a Dutch-themed brew-pub with full sit down restaurant and a complimentary family outdoor area featuring picnic tables, a kid's climbing wall and common family-friendly lawn games.

The parcel is a separate tax lot and the term sheet provides that Tenant will be solely responsible for all real estate taxes assessed against the parcel. The premises will consist of the entire parcel and Rotterdam Pub will be solely responsible for all operating expenses to maintain the interior and exterior portions of the premises, including parking and landscaping within the tax parcel. The term sheet defines Landlord's Work, below. Other than Landlord's Work, Tenant is obligated to obtain all permits and perform all work needed to open as a "Rotterdam Pub".

Landlord's Work means:

1. *Obtain site plan approval for the development of the pub restaurant and outdoor areas.*

2. *Construct the pub restaurant building structure, stub all necessary utilities to the building and perform various site work to grade portions of the premises for development of the picnic and gaming areas, to be more fully set forth in the Lease.*

Hypothetical #3

Your client, a boutique young adult clothing retailer ("**Jules")** with over one hundred (100) locations, sends you a term sheet for a multiple location expansion. They are partnering with Nomis one of the country's leading owners of enclosed shopping centers ("**National Landlord**") to expand into certain suburban markets of Florida and Georgia by signing onto a ten (10) store expansion. Your client already has stores in fifteen Nomis owned and operated shopping centers in the Northeast, which represent some of their earliest brick and mortar locations with the last deal completed in 2018. The term sheet you receive refers to the "Existing Form Lease" for several high level legal and business issues. You are familiar with the form lease, having negotiated it opposite National Landlord's in-house counsel for the prior locations.

The term sheet contains the following provisions:

1. *Landlord's Work: "All work necessary to deliver the Premises as a "vanilla shell" in accordance with Landlord's building standards.*

2. *Rent Commencement Date: 180 days after the day Landlord delivers possession of the Premises to Tenant with Landlord's Work substantially complete ("Delivery Date"); provided that, Tenant may toll the Delivery Date for up to thirty (30) days, if Tenant has not received its building permit to complete Tenant's Work as of the date possession is delivered.*

3. *Required Opening Date: 60 days after the Rent Commencement Date.*

We will use the above hypotheticals to illustrate and analyze the following concepts related to the negotiation of work letters and related provisions within commercial leases.

DEAL ECONOMICS AND THE INTENDED ALLOCATION OF CONSTRUCTION OBLIGATIONS

What's the deal? Before a letter of intent or term sheet (collectively, the "LOI") land on the lawyer's desk, there is often a significant amount of time and energy spent by the business teams to arrive at the structure of a deal, including timing, allocation of responsibilities and economics. In terms of Work Letter considerations, the LOI will set forth the salient deal terms and project types such as – "As Is", "Reverse Build To Suit", "Build To Suit - Vanilla Box" – and many variations of these commonly named deal structures . The LOI will also identify the land or space to be built or existing second generation space ("Premises"). The LOI should (but does not always) state the current condition of the Premises, the scope and allocation of the work responsibilities (which inform cost assumptions that flow through to rent and allowance), timing, coordination of all work and major remedies for failure of either party to perform.

Deal economics place an "As Is" delivery high on a Landlord's preference list in part because it is easier to underwrite with little to no work for the Landlord to complete. Some modified "As Is" deals for existing space may require a Landlord to deliver the Premises in structurally sound, watertight, and free of hazardous materials condition. Modified "As Is" deals may also layer into the delivery date obligations Landlord representations or warranties concerning the Premises or the condition of the broader commercial development, which can move the goal posts and create unforeseen costs for ownership. However, most "As Is" deals place a heavy burden on the Tenant to perform nearly 100% of due diligence and the construction work necessary for the Tenant to open for business. Specifically, Tenant may determine it necessary to perform extensive site investigations that may include structural, mechanical, environmental, title and geo-technical inspections. Scopes of due diligence will vary based on the property type, Tenant's budget and Tenant's appetite for risk assumption. Not all Tenants have the financial wherewithal to undertake pre-spend due diligence of this magnitude. As noted above, Tenants with less capital on hand and perhaps less leverage in a negotiation may seek to insulate against unknown property conditions by way of tying delivery of possession to certain Landlord representations that speak to existing property conditions.

To further emphasize the deal economics of "AS IS" deliveries, Tenant's assumption of risk is tied to the requisite project costs of purchasing expensive materials and mobilizing trades. Base rent tends to be lower and Tenants are well advised to negotiate room on their milestone schedules to insulate against rent commencement prior to construction completion. Allowances paid by Landlord may off-set some of Tenant's construction costs, but are often not available for distribution until after the Tenant outlays the funds or opens for business.

For some Tenant's the capital outlay and control over a build-out is worth it. Tenant does control nearly 100% of the project's cost, quality of build, and construction schedule, which may ensure better certainty of execution to get their business open in accordance with their specifications. For Landlords, the benefit of low initial capital outlay and a capped contribution via an allowance may be worth a lower future base rent over the term of the lease.

The "Reverse Build To Suit" deal is somewhat of a sliding scale middle ground – as negotiated -- for Landlord and Tenant. We note this deal structure includes the various monikers of "vanilla box" "grey box" deliveries. Landlord performs a portion of the work that may include pad prep and land and permitting approvals or some amount of demolition, demising and other work as negotiated for existing space (watertight, structurally sound, some mechanicals, HVAC, electrical, fire suppression). In these scenarios Landlord's work must sync with Tenant criteria and requirements, so before the deal can be finalized the Landlord should spend time and potentially money studying the condition of its Premises and the specific requirements under Tenant's plans. Tenant performs most of the work in this instance and relies on Landlord's initial scope of work to be completed in compliance with Tenant's requirements on an agreed schedule so that Tenant can timely complete its work and open for business on a schedule that aligns with the rent commencement date.

For land deals, Tenant will typically be responsible for all vertical construction after pad certification and delivery. For second generation space Tenant will perform the majority of its fit-out work with some related work (roof, HVAC, electrical, fire suppression) as negotiated; these are typically hotly debated items and impact work letter specifications, rent, schedule, and capital expenditure. As compared to an "As Is" structure, rent is higher to account for Landlord's upfront investment. Like "As Is" deals, Landlord can more easily secure financing –especially with a credit Tenant -- for Reverse Build to Suit land deals because the Landlord's capital outlay is typically equal to the Tenant allowance and any negotiated work Landlord agrees to perform. Conversely, the Tenant in this situation controls a significant portion of the process and will have to spend time and money performing due diligence to determine total capital outlay and structure appropriate deal terms within the lease. Tenant is mostly in control of the project's cost, quality, and schedule. Tenant outlays most of the capital needed to complete construction and can face challenges trying to secure financing if Tenant is not well capitalized.

Finally, there is a "turn-key" or a "Build To Suit" deal, Landlord undertakes significant if not all work including pad prep and certification, vertical construction (in a land deal) and Tenant fit out, or full interior build out aside from the final fixturing of Tenant's trade equipment. This work must meet all Tenant criteria and requirements and at times Tenant may dictate architects and contractors to be used. Tenant gives up the most control under this deal type in exchange for a relatively low capital outlay (which means it can theoretically open more units each program year). Tenant's work is typically limited to installing fixtures, furniture, and merchandising. Under this deal type, rent is the highest as Landlord has expended significant sums of money, performed all work and taken on all risk relating to materials and construction. For these reasons, a Build To Suit deal, especially on a complicated or large (expensive) project are very difficult for Landlords to secure financing in the current lending environment. Lending varies, but lenders are either on the sidelines or asking for 40+% down, recourse, additional money in the bank, and high interest rates. This coupled with fluctuating cap rate markets and budget busts from the initial pro forma to the time contracts are signed for materials and labor, constrain Landlord's dealmakers from attempting these deals.

<u>ASKING THE RIGHT QUESTIONS; DEVELOPING MILESTONE SCHEDULES,</u>

Development of work letters and the interplay of deal economics and allocation of construction responsibility is a fact-specific puzzle. The translation of facts from a term sheet or LOI into both a work letter and the inter-related lease provisions is not straightforward. The pieces to this puzzle are often missing when parties commence lease negotiation. In order to appreciate the underlying economics of a build-out project and the allocation of responsibilities among the parties, there are certain threshold questions that should be considered:

- How complete is the scope of work set forth in the LOI?

- Does "substantial completion" of each party's work obligations provide a clear demarcation of responsibility and a logical sequence for the completion of the build-out and opening of the business?

- What level of due diligence is needed for one or both parties to develop adequate knowledge of underlying title and survey related issues; environmental conditions; zoning, development and use rights or any other third-party approvals that may be needed for the proposed business to operate at this location?

Counsel should probe clients to understand the expected time, cost and complexity of their client's anticipated construction obligations, financing concerns and inter-related issues that may range from co-tenancy concerns for a Landlord to seasonal opening preferences for a Tenant. Asking the right questions of your client's construction expectations (cost, schedule) at the outset of a new matter facilitates a broader understanding of how best to expend negotiation chips within the upcoming lease negotiation. As a best practice, before drafting the lease, counsel should confer with its clients' business, design, and construction teams to level set on the project scope, status of the project to date, schedule, milestones (concurrent and successive), and level of specificity needed within the lease. We appreciate that many clients on both sides of the aisle enter into LOIs and request lease preparation before retaining construction teams or embarking on material due diligence. Nonetheless, even basic information from the business team regarding client expectations on build-out, delivery and rent commencement should help identify work letter and lease drafting critical issues.

Landlord may already have uniform delivery specifications, often identified as "building standards" that are imposed on all Tenants entering a shopping center. National-retailers, restaurant chains and other high-profile Tenants will often have their own design-build requirements that may require Landlord to alter these standards. However, most Landlords and Tenants may be entering deal-specific terrain without prior experience and without a full roster of professionals to guide them. In all scenarios, resolution of each party's design standards and construction specifications is often the first step needed to inform work letter preparation. Where critical gaps exist in the initial construction scope set forth on an LOI, counsel should encourage the business teams to engage to fill in the details on work letter specifications while the lease is negotiated. Leaving the work letter specifications as a plug-in at the end of a lease negotiation often leads to re-opening of previously negotiated terms and overall delays in lease execution.

Despite best efforts, construction budgets and completion schedules that serve as the introductory framework of a deal at the LOI stage, often need to be re-calibrated after diligence of a project progresses. Common due diligence questions that may warrant review of title, survey, environmental and geo-technical reports should be raised based on the scope of a client's work obligation. For existing space, are there existing plans, a current site investigation report (including environmental, engineering and MEP) or are new studies needed, which can be costly and time consuming if not planned for in advance. Underlying deal metrics matter and the result of understanding existing conditions may raise more questions or alter the deal type or terms – all of which may impact development of the work letter and tangentially related lease terms.

If for example, existing conditions yield concerns over a roof's condition, the adequacy of existing utilities or the decibel reading of sound intrusion from an adjacent tenant, the economic baseline of a deal may shift. While this process may require re-approval by real estate committees, partners, lenders and ultimately takes time, the logic is that addressing these diligence issues through an informed understanding of property conditions mitigates the potential for either party to absorb unforeseen construction costs after lease execution. When budgets are busted, who has the leverage in the deal to influence resolution? Again, dealing with this before leases are signed is preferable.

The synthesis of duties relative to construction plan development, project permitting and the chronology of Landlord and Tenant construction obligations in the field appears as some variety of a milestone schedule in the lease. Milestones may apply to each party's (a) right to review and approve the other party's plans, (b) duties to submit for permits; (c) obtain zoning, land use, or construction permits, (d) substantially complete work, and (e) clearly understand the punch list close out process, which work often occurs while Tenant is actively building, fixturing, merchandising and training in the space. The culmination of these milestones lead to key triggering events, which consist of the date possession of the premises may be delivered to Tenant and the date Tenant is obligated to commence rent payments to Landlord. There are often mutual benefits to developing a milestone schedule that considers deal specifics. However, it is imperative that this schedule aligns to the parties' general contractor schedules because those are often developed independent of the lease. A Tenant that is focused on a narrow window to construct and open before a specific high season may prefer to reduce Landlord's work obligation if Tenant believes it can move more quickly and control construction costs. A Landlord that is eager to re-let a space may be willing to invest more upfront expense into a build-out of the space and a longer lead time to a tenant to fixture the space and open for business.

<u>THE UTILITY OF COMMON LEGAL CONCEPTS</u>

Once the lease is signed, what happens when Landlord or Tenant dispute the scope of work responsibilities, experience delays in the field, discover unknown site conditions and ultimately absorb unforeseen costs? Despite the best efforts of Landlord and Tenant to draft specific work letters, the allocation of risk and the impact of such risk on each party's financial budgets warrant careful consideration and development of many inter-connected lease provisions.

<u>The Delivery Date</u>.

Much attention is often given to the day on which Landlord delivers the Premises to Tenant. No matter the type of build-out, this date - on a vast majority of deals - is a major milestone. Tenant now has possession. Landlord has, in theory, completed its construction obligations. Rent is usually now the next milestone date on the calendar, which is of utmost significance to both sides.

Landlord favors clear paths to the delivery date. Landlord is often out-of-pocket on construction costs with the delivery date serving as the trigger for eventual rental income. Landlord's favored position is a right to simply notice Tenant that its work is complete with the lease stating that Tenant will then accept possession upon receipt of such notice.

From Tenant's perspective, this approach is problematic. No matter the deal type, it is essential to Tenant to know when Landlord will deliver the premises because Tenant risks loss of time or capital if it is not prepared to accept possession on the delivery date. Tenant may need to have its merchandise ready, employees/staff available to train, contractors and supplies ready to build in the sequence necessary to efficiently utilize free rent periods that often follow possession dates.

Delivery Conditions

For this reason, Tenant prefer a lease provision that requires advance written notice of the anticipated delivery date, an opportunity to inspect the premises to confirm that Landlord's work is, in fact, substantially complete, and, in certain circumstances (seasonal black-out periods), the ability to delay possession of the premises until a future date. Tenant may require Landlord independently verify completion via an architect or general contractor certification. When deal leverage allows, a Tenant may tie the delivery date to certain covenants and representations that concern the Premises or operational aspects of the project. The logic is that a Tenant's best opportunity to police the condition of the Premises, Shopping Center and ultimately pin a Landlord to representations and covenants is to tie these protections to Landlord's ability to deliver possession (which often tolls the rent clock). As examples, protected exterior areas (e.g. parking areas, critical access routes) should be available for use and unimpeded. New violations of law (e.g. environmental hazards, code compliance issues) that could impact Tenant's ability to complete Tenant's work should be guarded against -- all with the goal (from Tenant's perspective) that on Day 1 of possession Tenant receives the benefit of its bargain both in respect to the Premises and the value Tenant placed in site selecting Landlord's building or center over other options.

Allowance Structures

Ideally, Landlord structures the allowance as a reimbursement and only pays the allowance to Tenant after completion of Tenant's build out and opening for business. Landlord may agree to installment distributions that are supported by Tenant's requests that are often contingent upon partial lien waivers and proof of Tenant's capital outlay in an amount that is equal to or greater than the amount of the allowance so requested.

However, the foregoing may not be a workable structure for a Tenant that requires the allowance to fund all or a portion of its construction costs. Here the work letter or lease provision could provide for scheduled release of the allowance upon certain milestones such as receipt of construction permit and additional distributions upon certain construction achievements with a final distribution upon receipt of a Certificate of Occupancy. If Landlord is coming out of pocket before the Tenant incurs the cost, Landlord has the right to require stronger oversight over the use of funds and will want to maintain a retainage often in an amount equal to 10-15% of the allowance.

Guarding Against Delays

Liquidated Damages. Financial penalties are the most utilized hammer to enforce delays on either side of the Landlord or Tenant aisle. Blown delivery dates, failure to timely obtain permits or approvals and missed required opening schedules are examples of events that either side may need to put "teeth" around in the form of a penalty that is intended to incentivize the other party's adherence to the negotiated dates. Liquidated damages can take any number of forms and are developed often an scaling schedules that utilize multiples of per diem rent (a metric often used to penalize a Landlord's breach) a percentage increase in base rent or acceleration of rent commencement (a metric often used to penalize a Tenant's breach)

While liquidated damages are a commonly utilized tool and the establishment of lease provisions concerning liquidated damages can be a rather simple drafting exercise, it is questionable how affective liquidated damages are in the field. If good faith and diligent efforts are undertaken and keeping in mind the likely capital constraints underlying many lease build-outs, attempting to extract significant financial damages for missed milestones may be counter-productive, especially when operating in the arena of non-credit tenants and lower tier landlords.

Outside Delivery Dates; Extensions. Instead, parties may look ahead and grant outside delivery dates or unilateral rights to extend certain construction milestones as attempts to provide reasonable leeway to another side that is performing in diligently and in good faith, to the extent deal specifics allow milestone goal posts to be shifted. If adequate advance notice is required by the party electing to push out a construction obligation, the logic here is that the other party has sufficient time to adjust its schedule and if that adjustment does not materially impact broader deal economics, the extension may build further trust and encourage the parties to work together toward the mutually desired end goal of project completion.

Landlord Delays & Tenant Delays. Both Landlord and Tenant should also consider the impact of the other party's delays on their ability to perform. Tenant Delays and Landlord Delays are commonly defined terms that insulate the non-delaying party from impacts that the delaying party may cause to a milestone schedule. Mutual notice obligations are often useful to set equal standards for each party to claim that a delay has been caused by the other party. As with excused delays caused by force majeure, Landlord and Tenant Delays often translate to day for day tolling rights for the affected party.

Third Party Interference. Tenant should consider the impact of third parties on their ability to construct and open for business. A property violation related to a third-party tenant's space that causes the local building inspector to refuse to grant a certificate of occupancy for Tenant's premises is not a frequent concern, but tenants do face these hurdles. Within centers that operate under reciprocal easement agreements ("REA) or similar project-wide cross-easement structures, Tenant should be mindful of the REA and how actions by and among Tenant, Landlord or other parties subject to the REA could impact construction projects. If Landlord has legal rights under another lease, the REA or contract to pursue a cure of a third-party related delay, a well-crafted lease will require Landlord to do so.

Self-Help Rights. Landlord may often seek to "step-in" to assist a Tenant that fails to obtain local permitting approvals. Tenant may want the right to complete punch-list work that Landlord fails to timely handle. These are examples of self-help related issues that often make sense in the field. Self-help is not always a viable option. Landlord may not want Tenant stepping into its shoes to perform structural, MEP or roof related work and Tenant often will not want to assume these obligations. In limited scenarios were the outstanding obligation can be undertaken by the other party, negotiation of self-help rights is a worthwhile lease provision.