Peer-to-Peer Session 12

Tenant Work Letters and Tenant Improvement Allowances: We Can Work it Out

Presented to

2024 ICSC+U.S. LAW
JW Marriott Desert Ridge Resort & Spa, Phoenix, Arizona
October 23-25, 2024

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Hypothetical #1 Payment of Tenant Improvement Allowance

Pat Dilbert is the owner and founder of Papa Pat's Pickleball Palace (P4), a trendy themed restaurant/entertainment/sports concept that is taking the country by storm. The success of P4 proved Pat could perfectly pair his two great passions: pickleball and delicious pickled vegetables. Besides endless opportunities to play and watch pickleball, take lessons from top pickleball pros, and watch topflight pickleball tournaments and league play, P4 offers a wildly popular selection of food and drinks featuring house-made pickled vegetables based on the Dilbert secret family recipe perfected by Pat's grandfather "Papa Pat."

After patiently searching for the right place for a new P4 flagship, Pat is finalizing negotiation of a lease for a perfect 40,000 square foot spot in a lifestyle center in Pittsburg, Pennsylvania. The landlord is New Life Development, which specializes in converting old enclosed regional malls into vibrant mixed use and lifestyle centers. The deal includes a Tenant Improvement Allowance and the lease contains a Work Letter with the following provision:

Tenant Improvement Allowance:

Provided that Tenant shall not be in Default under this Lease, Landlord shall pay Tenant a sum equal to the lesser of: (y) the actual cost of the construction of the Qualified Expenditures (as defined below) or (z) an amount equal to One Hundred Dollars ($100) per square of the Floor Area of the Premises (the "**Allowance**"). As used in this Section, "**Qualified Expenditures**" shall mean the actual cost of constructing or improving qualified long-term real property to be used in Tenant's business. Landlord will pay the Allowance in three (3) equal progress payments, when Tenant's Work is 33%, 66% and 100% complete. Each progress payment shall be paid thirty (30) days after the applicable percentage of Tenant's Work has been completed and Tenant has submitted an application for the progress payment in question. Each application shall be accompanied by (a) a statement executed by Tenant's general contractor that certifies to Landlord that Tenant has completed at least 33%, 66% or 100% of Tenant's Work, as applicable, and (b) and conditional mechanics lien waivers from all contractors and material suppliers who have supplied goods, labor or services pertaining to the invoiced work.

The application for the final progress payment may not be submitted until Tenant has opened for business to the general public from the Premises and paid first month's Rent. In addition, the application for final progress payment shall include the following:

(i) an affidavit from Tenant's general contractor, specifying all of the names, trade and subcontract amount, of all subcontractors and material suppliers furnishing goods, labor, services or materials in connection with Tenant's Work;
(ii) final lien waivers from all contractors, subcontractors, suppliers and professionals furnishing goods, labor, services or materials in connection with Tenant's Work;
(iii) a copy of a final certificate of occupancy (or its equivalent) for the Premises; and
(iv) a set of "as-built" plans for the Tenant's Work in auto CAD format.

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QUESTIONS:

1. What concerns might Pat have about the submittals and other requirements for payment of the Allowance?

    a) What changes might Pat propose to address these concerns?
    b) What objections might New Life raise to Pat's proposed revisions?
    c) What compromises might the parties reach?

2. At another P4 location, the landlord/developer experienced financial problems and Pat had a lot of trouble getting the landlord to pay the Allowance even after Pat had made all the proper submittals and satisfied the other requirements. What protections and remedies might Pat try to negotiate in this lease to reduce the chances of similar problems?

    a) What objections might New Life raise to Pat's proposed protections and remedies?
    b) What compromises might the parties reach?

Hypothetical #2 – Access and Coordination of Construction Activities

Suburban Outfitters ("Suburban") has identified a new retail development owned by Lenny Landlord ("Lenny") where they hope to open their first flagship 25,000 SF suburban sports experience, complete with top of the line suburban experiential areas such as bocce ball battlegrounds, a cornhole maze, flat-top grill test kitchens, a Yeti mountain climbing wall and creek-side fishing simulators. Based on recent experiences, Suburban and Lenny have become keenly aware that various supply-chain disruptions have made delivery of mechanical equipment FF&E and Suburban's inventory particularly difficult to reliably schedule.

Suburban and Lenny have agreed to have their design, construction and legal teams (the "Big 3") meet early in the lease negotiation process in order to coordinate all aspects of this development and to allow landlord work and tenant work to proceed in tandem.

Suburban's explicit corporate directive is to have their new flagship store at Lenny's open on April 1, 2025. Suburban has informed Lenny of this important schedule constraint and has planned its FF&E finish work and pre-opening activities (including training all new employees) based on this strict grand opening schedule. As a longtime landlord, Lenny has experienced his fair share of real estate cycles and wants to avoid any delays but recognizes the inherent risk in having multiple trades working for Lenny and Suburban at the same time.

QUESTIONS

1. What types of issues can the Big 3 prioritize and begin to allocate risk in these early meetings?

    a) Construction budgeting?
    b) Work phasing, milestones and scheduling?
    c) Liquidated damages?
    d) Detailing finish-out allowances?
    e) Responsibility for ordering and installation of long-lead items (i.e. mechanicals)?
    f) Responsibility for governmental approvals?

2. What types of issues should be negotiated and ironed out by the Big 3 in work letters and finalized before construction contracts are signed?

    a) Responsibility for delays of various types?
    b) Definition and risk allocation for force majeure events?
    c) What insurance and indemnity considerations should be addressed?
    d) How should utilities be handled?
    e) Substantial completion and risk of loss?
    f) How will punch lists and warranties be addressed?

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