

## In the Spotlight

### *Construction of Improvements to Premises*

By Jack Garson



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Whether leasing new or existing premises, whether you are the landlord or tenant, the construction of improvements to your premises presents numerous concerns. First, both parties should address and allocate a variety of risks that are unique to the construction of improvements to the premises.

Second, each party must try to incorporate protections against potential problems. Finally, each party should attempt to anticipate and provide for those special construction concerns that are unique to the premises in question.

The lease provisions addressing construction of improvements to the premises present not only complex clauses and unique jargon, but also numerous opportunities to negotiate the allocation of important risks.

#### **TENANT OBLIGATIONS**

In a ground lease, for example, the tenant generally will be required to perform all improvements to the premises except, possibly, infrastructure improvements to the site. Similarly, a tenant may lease the premises in its “as is” condition. In a more typical scenario, the landlord provides either a “cold, dark shell” — no HVAC or ducting, no lighting, but usually an electric panel and perimeter/demising walls, doors, and a storefront — or a “warm, lit shell,” which includes HVAC and usually the thermostats and ductwork, building standard lighting, such as 2x4-foot fluorescent lighting, ceiling tiles and grid, and the standard walls, doors, and storefront.

#### **PERFECT WORLD?**

Occasionally, the landlord will provide a “turnkey” build-out, where the landlord constructs all of the improvements to the premises per mutually agreed-upon plans and, in a perfect world, all the tenant needs to do is turn the key, put the inventory on the shelves, and plug in a few pieces of equipment.

All of these construction scenarios involve certain risks. Notably, the parties face:

- The risk of delay in construction;
- The risk of cost overruns;
- The risk of nonpayment (for the improvements) by the responsible party; and
- The risk of incomplete or defective work.

The risk of delay, for example, might mean that the landlord fails to complete required work on time, and the tenant misses a critical selling season. The risk of cost overruns might mean that a landlord performing work for the tenant, at the tenant’s expense, exceeds the tenant’s budget, draining the tenant’s operating capital and thereby limiting the potential success of the tenant’s business.

Likewise, a tenant that is unable to pay for the construction may subject the landlord’s property to liens imposed by the tenant’s contractors. Defective work can also present significant risks.

## **NOT A MAGIC CARPET RIDE**

In one notable case, where a landlord agreed to “complete” work for the tenant, versus “substantially complete” the work (with exceptions for “long lead” items), the landlord was prevented from delivering the premises and collecting rent for almost 1 year when the last run of a specified color of carpet had already been sold and the landlord had to wait for the mill to begin another batch in the next season.

## **TENANT RIGHTS**

Where the landlord performs the tenant improvements at the tenant’s expense, the tenant can employ a number of protective measures such as:

- Require multiple bids for each major task to ensure competitive pricing;
- Entitle the tenant to invite contractors and subcontractors to bid on the work, again helping to ensure competitive pricing;
- Fix the amount of the general conditions, profit, and overhead that can be charged by the contractor and subcontractors performing the work and limit or eliminate any landlord fee for construction management. Likewise, cap the fees that can be imposed for change orders;
- Impose penalties, such as abatement of rent, if the landlord delivers the premises late and establish “blackout” periods when the tenant is not required to take possession of the premises; and
- Employ an architect or construction consultant to examine the quality of the landlord’s construction and clarify the landlord’s obligation to timely correct punch list items.

## **LANDLORD RIGHTS**

Similarly, where the tenant performs its own improvements to the premises, the landlord can seek a variety of protections such as:

- Confirm that the tenant has sufficient funds to pay for all the anticipated improvements;
- Require the right to approve the tenant’s general contractor and architect;
- Require the right to review and approve the tenant’s plans and specifications;
- Require the tenant to procure and provide the landlord with the proper permits and insurance;
- Require partial lien waivers during the course of construction and a final lien waiver at the completion of construction from not only the general contractor, but also from all subcontractors and each supplier providing more than a specified dollar amount of materials;
- Require architectural certification of completion;
- In large projects, require the tenant to furnish payment and performance bonds from an approved surety.

In addition to common concerns and solutions, each premises has the potential to present unique problems that require foresight and planning. The existing premises that a tenant is about to lease might require a sprinkler system, but the water pressure in the area may be too low. Consequently, the tenant may be required to install a holding tank to ensure adequate water pressure, a considerable and unanticipated expense.

## **RESTAURATEUR RIGHTS**

The premises that a landlord decides to lease to a restaurant, instead of a more typical retail merchant, may trigger a requirement to provide an additional means of egress or more common area parking, causing considerable construction cost increases and substantially delaying delivery of the premises. The premises that a tenant leases “as is” may contain code violations or hazardous materials, complicating and increasing the cost of construction. Each time a landlord or tenant approaches the task of constructing improvements to premises, it faces certain common and sometimes unique, unanticipated problems. Careful consideration of these concerns and the negotiation of appropriate protections can dramatically reduce the potential for costly problems. The bottom line for both parties: Plan for problems, and you will often avoid them.

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