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By Joel S. Brudner
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AN OVERVIEW OF TENANT WORKLETTER OBJECTIVES

The tenant work letter is an agreement that sets forth the terms within the lease upon which the initial tenant improvements are to be built. The work letter is an integral component of any commercial lease and is consistently studied in detail by several service professionals following the execution and delivery of the lease. In addition to the landlord and tenant, the construction manager, the architect/design team, the contractors, and the lender will typically review the work letter. Despite its importance, this part of the lease is often overlooked by tenant and its counsel in favor of more pressing legal and economic issues in the body of the lease. The work letter itself presents several very important issues such as which party is to be responsible for the construction of the tenant improvements, controls the schedule, the cost, the quality of design, and the quality of construction.

The critical factors are time and money since the cost of the tenant improvements is ultimately borne by the tenant, either directly during the course of construction and immediately following completion, or indirectly, throughout the lease term as a portion of the rent via the landlord's allowance.

The typical lease scenario provides for either the landlord or tenant to be responsible for the physical construction, while the costs are either "turnkey" wherein the landlord is financially responsible for all improvements required, or some combination of the parties sharing the financial burden. The extent for which the landlord has agreed to fund its portion is typically referred to as the "Landlord Allowance" or "Construction Allowance."

The definition of this Construction Allowance and the language prescribing what is included as well as parameters under which the work is to be performed are the critical areas of the documents. If diligently prepared, these documents provide maximum value for the tenant's improvements and protect the tenant from costly oversights.

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Construction Allowances are normally based upon the square footage of the premises, e.g., \$30.00 per rentable square foot. The documentation must specify exactly which construction costs qualify as expenditures under the allowance. It is often clear which costs should be *excluded*, such as in the case of costs for the base building structure, and in the case of building standard work furnished to all tenants by the landlord, while in many cases, it may not be entirely clear. The construction allowance exhibit should include a carefully drafted definition of "construction costs" in the documentation. The working definition of construction costs frequently includes:

- Fees paid to engineers, architects, interior designers, and space planners to prepare plans, specifications and drawings for the work;
- Costs of all labor, materials, and fixtures (but not trade fixtures) supplied by the contractor and subcontractors;
- Costs of on-site inspection, administration and supervision of the construction process; and recording and filing fees required by the construction.
- Taxes, licenses, charges and levies imposed by governmental authorities in conjunction with the construction of the improvements in the premises;
- Fees paid to utilities to connect to the premises, as opposed to the overall "trunk" lines for the entire retail or office complex;

Many items are debatable as to whether they should be included in the Construction Allowance. It is advisable to expressly include or exclude certain items from construction costs that may have the potential to cause misunderstandings between the landlord and the tenant when the parties review the accounting for tenant improvements such as:

- costs for work performed before the lease was signed;
- off-site improvements such as streets, curbs, gutters, parking lights, street lighting, and so forth;
- improvements made outside of the demised premises;
- building-wide systems such as elevators, HVAC, electrical panels, staircases and the like;
- the cost of items furnished by the landlord as "building standard work" above the "base building construction";
- costs for items not shown or detailed in the approved plans and specifications for the tenant improvements;
- costs covered by warranties and insurance;
- premium or "overtime" wages and costs incurred to complete tenant improvements on time;
- financing costs, points and fees expended in connection with the financing of the tenant improvements;

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- costs or premiums for performance bonds, mechanics' lien bonds, completion bonds, and payment bonds;
- insurance premiums for builder's risk insurance, liability insurance, or casualty or worker's compensation coverage;
- costs of interior or exterior tenant signage;
- costs to remedy construction defects;
- costs to remove or abate asbestos, PCB or other hazardous materials;
- charges to rent construction equipment used to construct the tenant improvements;
- costs of changes to the plans and specification required by governmental authorities, and the cost to retrofit such changes if the affected improvements have already been constructed;
- general overhead of the landlord or tenant, or of their respective contractors or agents;
- legal fees related to the construction contract and construction management contract negotiated and executed by the landlord, the general contractor, and subcontractors for the tenant improvements; and
- legal fees related to any disputes arising during or after construction of the tenant improvements.

The tenant must also insist that it be afforded the same conditions as would be in existence for the landlord or its contractors, so that no unreasonable costs or delays are incurred. For example access to elevators for moving materials, carting of debris, or hours of operations should be no more restrictive for the tenant undertaking the improvements.

Typically, both the tenant and the landlord will seek to control the expenditure of the tenant improvement dollars. The landlord's primary concerns are economic, including receiving rent at the earliest possible date and maximizing the return on the landlord's leasehold improvement investment. The landlord also argues that as the owner of the building, it has a superior interest in controlling the construction of improvements and its use of construction dollars for financeable and reusable improvements (*i.e.*, improvements usable by a wide variety of office users as opposed to those specially designed for a tenant's business). The landlord also has an interest in minimizing the expenditures, mitigating the landlord's liability for design and construction defects, achieving uniformity in construction, taking advantage of the economies from multiple construction projects within the building, controlling scheduling, and protecting other tenants from interference with quiet enjoyment.

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The tenant's basic objectives are meeting the tenant's specifications and particular business needs, completing by the date necessary to meet the tenant's business objectives while minimizing disruption of the tenant's operations, containing the tenant's costs, and avoiding responsibility for base building and other landlord portions of the improvements.

The conflict is over control of the costs, schedule, and qualitative elements of a design and construction project. Understanding that improvement costs are ultimately borne by the tenant, its objective is to take control of the expenditure of those funds and gain every advantage that buying power provides. Also assurance that value judgments, compromises, and related decisions impacting time, money, aesthetics, or function are made by or in the interests of the tenant is critical.

Several factors are relevant when evaluating the control issues related to the construction of the improvements. These include: tenant's level of sophistication as to construction, leverage in the market, time constraints, existence of code or hazardous waste issues, landlord's financial ability to perform, and the allocation of financial burden to each party. Once the parties' responsibilities are established, there should be specific guidelines in the document to account for construction delays versus penalties, payment procedures, insurance, and project change orders. Determination of substantial completion for occupancy should be well defined as should a logical and swift process for handling punchlist items.

Tenants should evaluate the advantages of taking control of the leasehold improvement process if the conditions and leverage allows. This would enable the tenant to maximize its potential savings in the construction of the improvements. If the tenant must accept a landlord build, it must negotiate fully the terms of the work letter to ensure timely completion and cost containment of the expected quality of tenant improvements.

At issue is control, which coupled with protective unambiguous documents, will translate into time and money.

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