

Use Work Letter Agreements to Ensure Renovations Run Smoothly

Work letter agreements are contracts that establish the terms and conditions of structural changes that leased space will undergo in preparation for a tenant's occupancy. Usually entered into when an owner and a tenant sign the lease, work letter agreements can take many forms. Often they describe arrangements in which the owner agrees to pay for a dollar amount worth of improvements and the tenant agrees to pay for improvements that exceed that amount. No matter what form they take, work letter agreements must be as specific as possible to be effective, experts agree.

"Don't leave anything to be worked out in the field," says Illinois attorney Carole Pechi. In a rush to close a deal, owners and tenants sometimes enter into work letters that don't obligate either to do more than just agree to agree, according to Pechi. "It never works," she says. "At the very least, you must have a cost cap on either what you're willing to reimburse the tenant for, or how much work you're willing to do, in terms of dollars."

Pechi says she often prefers work letter agreements that are even more specific, establishing exactly what changes the space will undergo.

"Specifying the scope of work that will be performed is important because the tenant might be planning construction that you're not willing to have done to your building," Pechi says. "You have to figure out what you'll allow the tenant to do and then figure out the overall cost for everything."

Designate Responsibility for the Unknown

While effective work letter agreements must be specific, it's not practical or necessary for tenants and owners to enumerate or anticipate the exact materials, labor, or equipment the improvements will require.

"You don't have to enumerate the cost of each little item, but you can figure out generally how much everything will cost and then set the cost cap at that amount," Pechi says.

Because work letter agreements often don't go into painstaking detail, it's important that they include definitions and assign categories of responsibility, experts say. For example, a clear definition of what qualifies as a "base building improvement" or a "base, shell, and core" can be helpful, says Susan Fowler McNally, a partner in the Santa Monica, Calif.-based law firm Gilchrist & Rutter. That's because work letter agreements almost always provide that these improvements will come out of the tenant's Pocket. For a sample work letter agreement clause that defines "Base, Shell and Core" improvements, see the Model Clause on p. 3.

If a work letter agreement says the owner will pay for a specific dollar amount worth of tenant improvements, McNally says the agreement also should clarify what the tenant may purchase with its improvement allowance.

"Typically owners do not want the tenant improvement allowance to be used for equipment, personal property, furniture, or other items that will not become the owner's property at the end of the term," McNally says.

"Owners also usually aren't willing to pay for items that probably won't be of value to future tenants."

When the improvement plans include tearing down old walls, work letter agreements should address whether the owner or the tenant is responsible for what's behind them, according to New York City attorney Stuart Byron.

"In my experience, if there winds up being asbestos behind the walls, it's the owner's problem and the owner's obligation to get rid of it," Byron says. "Everything else revealed by the demolition should be the tenant's responsibility."

Go Beyond Material and Labor Costs

McNally advised that, in addition to divvying up the costs of materials, equipment, and labor, work letter agreements should address the following issues:

Insurance. "If the tenant is constructing its own improvements, there should be a provision specifying the insurance the contractor and the subcontractors are required to carry," McNally says. The work letter agreement also should specify that the contractors' and the

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subcontractors' commercial general liability policies must cover the owner as an additional insured.

Lien releases. The work letter agreement should establish that the tenant's contractor and subcontractors will provide lien releases to the owner, according to McNally.

Retaining the architect. The tenant should always be responsible for hiring the architect or the space planner who prepares the plans, even if the owner is paying those service providers' fees, McNally says. According to her, the agreement should also make it clear that the tenant will provide the architect or space planner with its program requirements and other space needs on a timely basis. "That helps to insulate the owner from liability related to the owners' potential failure to make sure all of the tenant's desires were included in the plans and specifications," she says.

Due dates for tenants' contributions. If the work letter agreement provides that the tenant must pay a portion of the cost of the improvements, when is the payment due? "The tenant should pay either 100 percent up front or 50 percent in advance and 50 percent upon completion of the improvements," according to McNally. "These amounts should be based on the contractor's guaranteed maximum price or stipulated sum bid." Alternatively, she says, the tenant can pay its share monthly, as the contractor's monthly payment applications are submitted.

Due date for first rent payment. The tenant's obligation to pay rent – also known as the commencement date – is usually triggered by substantial completion of the tenant improvements. "Clarify what must occur before the tenant improvements are deemed substantially completed," McNally advises. She uses the date on which the certificate of

occupancy is issued or the date on which the building permit is signed as examples of potential commencement dates.

Right to terminate. If the tenant is constructing, then the owner should make sure the work letter agreement establishes a right to terminate the agreement if the improvements are not completed by certain date, McNally says.

Warranty assignments. The party hiring the contractor should require the contractor to guarantee the work will be free of defects in materials and workmanship for at least one year, McNally advised. "This warranty should be freely assignable," she says. "If the owner's contractor constructs the tenant improvements, the owner will want to be released from liability for defects upon assigning the contractor's warranties to the tenant."

Finally, designate a decision maker in the work letter agreement and include his or her contact information, Pechi suggests. "If there's an unanticipated question, you'll need one," says Pechi. "And there will always be questions. You can't cover all the basis."

Insider Sources

Stuart Byron, Esq.: New York, NY

Susan Fowler McNally, Esq.: Gilchrist & Rutter; Santa Monica, CA

Carole Pechi, Esq.: Laude Pechi Law LLC; Glen Ellyn, IL

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Model Clause

Define Key Terms in Work Letter

The following Model Clause defining "Base, Shell, and Core" is an excerpt from a work letter agreement drafted by Susan Fowler McNally. Show this Model Clause to your attorney before adapting it for a work letter authorizing tenant improvements to your space.

For more excerpts from the Model Work Letter Agreement, check your email inbox for the next *Commercial Leasing & Property Management E-Alert*.

Base, Shell, and Core

The "Base, Shell, and Core" shall consist of the Building shell and exterior; the core area, including the necessary mechanical, electrical, sprinkler, plumbing, life safety, heating, air conditioning, ventilation, and structural systems within the Building core, stubbed out to the face of the core wall at locations determined by Landlord; finished core area toilet rooms including necessary plumbing fixtures, ceramic tile floors, accessories, ceilings, and lighting; and those portions of the Premises which were in existence prior to the construction of the Tenant Improvements. Tenant hereby accepts the Base, Shell, and Core in their present "as is" condition and with no representations or warranties as to their condition or suitability for Tenant's purposes. To the extent the Base, Shell, and Core must be changed or added to in order to accommodate the special needs of Tenant in the Premises, such changes or additions shall be considered Tenant Improvements (as defined in Section [insert #]). Any items provided by Landlord in the Premises in addition to the Base, Shell, and Core shall be paid for by Tenant, subject to Section [insert #] below.