Delivery of Tenant Premises: Increasing Risks Facing Both Landlords and Tenants

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The supply chain challenges brought on by the COVID-19 pandemic, as well as the war in Ukraine, have greatly increased the risks for commercial landlords and tenants relative to the buildout of tenants' premises. Accurate cost estimating has been impacted, as well as timely delivery of the space.

Landlords are typically tasked in a lease with delivering tenants' premises by a certain date and in any of a variety of industry-specific conditions, such as Turnkey (move-in ready), a Vanilla Box (ready for finishes with utilities installed), or a Cold Dark Shell (without interior improvements or utilities installed). Lease negotiations regarding the condition of the premises being delivered to tenant, as well as the delivery date itself, are in essence an allocation between landlord and tenant of the costs, risks and responsibilities that arise in connection with the buildout of the premises being leased.

Traditionally, where a landlord agrees to deliver the premises in a specified condition and the tenant agrees to assume the cost of any additions, both the landlord and tenant are able to budget for their respective risks. For example, where a landlord fully understands its delivery obligations regarding the condition of the space, the landlord will price the cost of its work with its preferred contractor to ensure that the rental rate covers the cost. Similarly, a tenant will have the ability to control and evaluate any proposed additions to the landlord's promised work, which will be at the tenant's cost.

Today's supply chain disruptions are challenging this traditional process by creating risks of an accelerated increase in construction costs and delays that have not been experienced in many years. Scenarios now exist where the buildouts that were priced and incorporated into rental rates increased by 25% to 50% within a matter of months. In response, contractors tasked with buildout obligations are now including material escalation charges in their contracts, as well as fuel surcharge provisions, so that even if the landlord has negotiated a fixed price contract, that contract value escalates alongside the rise in material and fuel costs.

To avoid these circumstances, landlords need to begin recognizing this risk in advance and reaching reasonable agreements regarding its allocation. One way to do this is to include a lease provision that allows for the sharing between the parties of documented escalations of material costs over an agreed-upon percentage, either by way of a cash payment from tenant, or by way of an automatic adjustment to the lease rental rate amortizing the cost increase into the rents. This approach will allow the landlord to recapture at least a portion of its increased material costs. Another effective approach is for landlords to avoid Turnkey agreements in the first place and to either cap landlord's buildout costs with tenant paying the balance, or to provide for payment of a fixed allowance sum from landlord to tenant, with tenant performing all of the work. By allowing the tenant to oversee its own construction, the tenant assumes the responsibility of budgeting the buildout and dealing with any cost escalation. However, with an increasing demand for more premium space and an unprecedented tenants' market, many tenants may be insistent on a Turnkey delivery.

In addition to cost increases, completion of the buildout work and the delivery dates of commercial space to tenants have been impacted by the recent supply chain disruption. In a typical scenario, where the landlord fails to meet a delivery deadline, the lease provides for rent abatement, rent credits, and/or an option to terminate by the tenant. In light of the current disruptions, however, late delivery is now becoming more likely. The typical lease options, which assume that the landlord possesses a high degree of control over the completion date, are becoming far less attractive to landlords, who are finding it difficult to meet delivery dates due to delays in supply of essentials components, from HVAC units to items as common as doors and lumber.

One potential resolution for this problem is for the landlord and tenant to discuss the various issues that may delay buildout work during lease negotiations and to categorize the risks in one of three ways: a landlord delay, a tenant delay, or a force majeure delay, which should expressly account for supply chain disruptions due to pandemic and war. The landlord should then propose to extend the commencement date under the lease for a reasonable time for delays caused by force majeure, such as one day for each day of delay. From there, the parties can discuss more typical options, such as rent abatement and termination dates, but they can then assign different values to delays caused by the landlord than those caused by force majeure. The tenant is not likely to agree to an unlimited accommodation, but the idea is to create a buffer zone for the landlord by allocating and sharing the risks associated with supply chain disruption up front and in a transparent and reasonable way.

Another concern for tenants when dealing with delivery delays are the holdover charges with their existing landlords. While the typical pre-pandemic scenario was that the existing landlord held most of the leverage during a typical holdover situation, in the current market, the tenant may be able to reach an agreement allowing it to continue occupying its existing space beyond lease expiration. It is likely that the existing landlord is experiencing the same problems as the new landlord, and so the existing landlord may be more willing than normal to allow for a special arrangement. Likewise, it is possible that the new landlord has some available vacant space that the tenant could occupy on a reduced basis pending resolution of the delays. Both of these options can be used to help deal with a tenant's holdover anxiety during negotiations.

In addition to higher construction costs and delivery delays, many landlords also face new challenges regarding reduced occupancy rates which began during the pandemic and continues well into the so-called post-pandemic period. With these reduced occupancy rates, much of the leverage during negotiations has shifted to the tenants' side. As a result of the general labor shortage and an increase in remote work brought on during the COVID-19 pandemic, many tenants are now expecting premium space that will entice workers back to the workplace. Consequently, many landlords are now overextending with respect to tenant improvement allowances, as well as accepting tenants with substandard credit.

When the allowance is substantial or the tenant is particularly risky, the landlord should consider their options to mitigate the risks associated with build-out costs. One option is for the landlord to require the tenant to post a letter of credit for all or a portion of the landlord's buildout costs. The letter of credit can be structured to expire upon the tenant's occupancy and should therefore pose no significant cost to the tenant. Alternatively, a landlord can require the tenant to deposit their share of the construction costs into escrow. The deposit can be made up front or, if the tenant is hesitant, over time, as construction progresses. Of course, landlords should also continue to negotiate for personal guarantees from the owners of the tenant. If the tenant resists, the landlord can negotiate for a guaranty that is limited to the costs paid as an allowance or incurred in the buildout.

From the pandemic, to war, to the rise of the remote workplace, the marketplace is radically changing on a monthly basis and will probably continue to do so. With federal infrastructure spending likely to increase in the near future, resources may be squeezed tighter and construction costs may continue to rise. Consequently, commercial landlords must be sure to have the negotiating tools necessary to mitigate the risks of these rising costs. It may be the difference between a profitable, long-term relationship and a lawsuit. **DP**

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