THE PROBLEM-SOLVING TOOL FOR RETAIL LAW

RETAIL LAW STRATEGIST

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NET-working
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By Michael Tubridy

State Legislation Targets Employers of Undocumented Workers

The failure of immigration reform in Congress last year only shifted the battleground from the federal to the state level. With a heavy concentration of undocumented workers in construction and food service, shopping centers will need to consider the implications of four articles that describe the background behind state bills that penalize employers who hire illegal aliens.

Employer sanctions represent just a part of a larger groundswell of state legislation aimed at immigrants. In 2007, over 1,500 bills related to immigration and immigrants were introduced in all 50 states, of which nearly 250 were enacted, according to "Federal (In)Action: It's Hard to Get

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Avoiding the "Gotcha"—Build-to-Suit Construction Issues

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Build-to-suit leases are transactions in which a property owner agrees to construct a particular building needed by a tenant, and the tenant agrees to lease this building for a term that will permit the landlord to have a profitable return on the value of the land and his construction costs. In a build-to-suit lease, the landlord functions as the tenant's construction contractor. Even if the landlord turns the actual building responsibilities over to a builder, the tenant and landlord will look directly to each other for the construction of exactly what the tenant wants and the payment for that construction by means of the tenant's rent.

As a result, a build-to-suit lease should include a construction contract. In many cases, however, the parties ignore the construction aspects of the contract while they battle over the lease provisions that govern the obligations effective after the building has been built. Later, they clash over what was supposed to have been constructed and what is necessary for completion.

When the landlord seeks additional compensation for asserted changes in the building or when the tenant refuses to approve even a reasonable substitution and demands a rent reduction, then the parties may find themselves caught up in a "Gotcha" situation—a technical dispute that delays lease commencement and costs both parties time and money. For example, was the landlord supposed to have paid for the sign? Was the landlord supposed to have provided a necessary median cut? Can the landlord substitute one piece of specified equipment for another quickly if the equipment originally specified turned out to be unsuitable? These disputes can be avoided if the parties draft the lease with the actual location in mind and try to anticipate glitches in the construction process.

1. Be Sure the Site Is Suitable for the Improvements.

Before it signs the lease, the landlord should examine the site, the availability of utility services, the zoning of the property, the access points and any off-site improvements that may be needed. Unlike a construction contract situation, in a build-to-suit lease, the landlord owns (or will own) the land on which the project will be built, and the tenant expects the landlord to know this property and to be responsible for any foreseen or unforeseen problems with its development.

Since the tenant will impose deadlines on the landlord for construction and completion, and before it binds itself to fixed dates, the landlord needs to identify whether re-zoning or re-subdivision will be needed, whether there may be problems in obtaining water rights, whether the municipality has extended all utility services to the site,

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whether an active neighborhood group may block permitting and other such potential problems. If the landlord knows that certain matters—for example, obtaining a zoning variance or permitting—could cause delays, it should identify them in the lease and provide that the deadlines will be extended for these delays. Even if it identifies matters that will cause a delay, the landlord should assume that other, unforeseen, delays will occur, and the landlord should extend the deadlines to several months after it thinks it will finish construction.

The landlord should also identify infrastructure issues that may require changes in the construction. For example, if the municipality has not extended all utilities to the site, the landlord should not gamble, but should have the tenant agree in advance that the landlord may provide temporary alternative utility services until the municipality provides the services.

On the other hand, the tenant needs to be sure that it has done all of its investigations and satisfied itself with the site before the landlord starts construction. Most build-to-suit leases for national tenants require the landlord to warrant that the property is free from hazardous substances, that the zoning will permit the tenant's intended use, that proper access is available and that title is clear. Nevertheless, the tenant should not rely completely on these warranties. The tenant should provide for an inspection period that will permit it to perform its own entitlement, title and physical inspections.

In addition, the tenant should determine in advance the off-site amenities that will be needed at the particular site, and obligate the landlord to provide these off-site improvements. For example, if the tenant wishes to have access to the site from an abutting shopping center or a private road, it should expressly require the landlord to provide this access and, if necessary, require the landlord to pave the neighboring property, provide curb cuts and obtain the necessary easements.

If the landlord learns that it might not be able to obtain any of the variances, water rights, utilities or permits that are needed, then the landlord should include a provision that permits it to terminate the lease without liability to the tenant. Similarly, the tenant will want the right to terminate the lease if the tenant's investigations show that the site is not satisfactory. If the landlord is going to acquire the property for the tenant's use, then both parties' investigations and right to terminate need to be triggered before the date on which the landlord can terminate its purchase agreement. In any case, each party needs to know whether the other party will be able to go forward before spending substantial sums. Consequently, the investigation period will be fixed, and both parties will need to be sure about the property before its end.

It must provide enough information to prevent the landlord from later scrimping on the construction materials, the size of the improvements, the design details or the equipment. The only way the tenant can be sure that it will get what it wants and expects is to be as specific as possible.

In the lease, the parties should specify which party should bear the investigation costs if the lease is terminated. If the lease goes forward, then the cost of title commitments, surveys, environmental inspections, and the like can be borne by the landlord and priced into the rent. However, if the tenant terminates before construction starts, the landlord may want to require the tenant to pay some of these costs—unless the tenant can show that its termination was based on a deficiency in the property that is contrary to one of the landlord's representations. Conversely, the tenant may want to impose its costs on the landlord if the property did not have a promised quality.

2. Identify What Is to Be Built.

Both parties will have problems if the lease does not identify with some certainty what the landlord is supposed to construct. Before it signs the lease, the landlord must be able to determine whether the site is suitable for the tenant's proposed improvements; a reasonable timetable for construction; and an estimate of the cost of construction, both to establish the rent and to arrange for sufficient financing.

From its point of view, the tenant wants the landlord to put in place all, not just part, of the improvements and equipment that it needs for its business. It must provide enough information to prevent the landlord from later scrimping on the construction materials, the size of the improvements, the design details or the equipment. The only way the tenant can be sure that it will get what it wants and expects is to be as specific as possible.

Both parties will be best served if a set of preliminary design drawings—or

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the tenant's prototype plans and specifications—are attached to, or identified by the preparer of, and the date in, the lease. The landlord then knows what it is supposed to build and to finance, and the tenant can counter any landlord arguments that the tenant misrepresented the extent of the improvements. A general statement that the landlord will construct the tenant's then-current prototype without something showing this prototype is likely to lead to problems for both parties.

Of course, neither party wants to pay for extensive or site-specific plans and specifications before the lease has been signed and the contingencies have been satisfied. So, the lease needs to contain a mechanism for the preparation of these detailed plans by the landlord and their approval by the tenant after the inspection period has ended.

A savvy landlord will request that the tenant agree to pay for all features or equipment that are outside the scope of the conceptual drawings or prototype plans that were attached to the lease. The landlord should also ask that the tenant respond to all plans presented to the tenant within a certain number of days and that, in its response, the tenant either approves the plans or disapproves them with notes that show the areas that are not satisfactory.

The tenant will also want to place time restrictions on the landlord and will require that each necessary stage of the plans and specifications be presented to it by a certain date—which may be measured from the execution date of the lease or in the later stages of plan approval, from the date of the tenant's last comments. The landlord may ask that plans submitted to the tenant be deemed approved if the tenant does not respond to them within a certain period of time; however, many tenants do not want to run the risk of inadvertently being bound if there are delays in the plan review. This can generally be worked out by a stipulation that if the tenant delays beyond a certain date, then deadlines for the landlord's completion of construction will be extended by the period of the delay—but that the rent commencement date will not be similarly extended.

The parties may want to provide a right of termination if the lease is not specific about the improvements and if the parties are subsequently unable to agree on final, detailed plans. This creates an impossible situation for a landlord that has acquired land specifically for the lease; consequently, termination should not be permitted after the inspection period contained in a purchase agreement has passed. A lease that permits termination if the plans cannot be finalized should also specify either that each party pay its own costs or for some capped reimbursement of costs by one party to the other.

The parties need to agree on procedures for the preparation and approval of change orders. The landlord may want to be able to make changes that are required by law or that are necessary to obtain permits without the tenant's consent. The tenant, on the other hand, will not want the landlord to be able to substitute materials or change design or functional features of the improvements—but the tenant will want to be able to require the landlord to make changes that it determines are necessary after final plan approval.

Generally, the parties can establish timetables for the approval by the tenant of changes requested by the landlord and approval by the landlord of changes requested by the tenant. If the tenant requests changes to the plans that will cost additional money, then the lease should require that the tenant pay these amounts, either in a lump sum before or during construction, or by means of an increase in the rent that will amortize the improvement costs, with the agreed interest factor.

3. Specify Completion and Acceptance Requirements.

The tenant will want to be sure that the improvements have been constructed in accordance with the approved plans and specifications, that all utilities are connected, and that all mechanical systems are functioning properly; therefore, the tenant will want to inspect and approve the improvements before they are considered completed. The landlord's goal is to prevent the tenant from rejecting the improvements unless those improvements do not comply with the final plans. The lease also needs to stipulate that the parties will prepare and agree to a punch list, and that the landlord must complete the punch-list items by a certain date.

At this point, the landlord is in a hurry to have the tenant open for business and start paying its rent (or its full rent if partial rent is paid during construction). The landlord will also need to meet its construction completion deadline and avoid incurring penalties. (Too frequently, delays cause the date of actual completion to be uncomfortably close to the deadline.) Consequently, the landlord will try to place time limits on the tenant's approvals to give the tenant representative an incentive to review the improvements and punch list promptly. On the other hand, as in the case of the final approvals, most tenants want to be sure that the right tenant representatives have given their final sign-off on completion and the punch list, and will not want this approval to be deemed to have been given without an actual signature by the specified representative.

One possible solution is a provision stating that if the landlord has provided the tenant with the landlord's architect's acceptance certificate and punch list, and if the tenant does not respond within a particular time period, then the tenant is not bound by the certificate or punch list, but the rent will start anyway. This satisfies the landlord's goal of beginning the

recovery of its investment and the tenant's concern that its managers have sufficient time to give considered approval of the completed improvements.

Of course, before the improvements can be considered completed or even substantially completed, the tenant will also want the landlord to provide it with the following:

- A certificate of occupancy; however, a temporary certificate of occupancy may be acceptable if the landlord promptly provides it with a final certificate of occupancy when all punch-list items have been completed;
- A copy of all warranties and the right to enforce them; and
- Lien waivers from all contractors and significant subcontractors.

Most tenants will require that the landlord furnish them with an "as built" survey within a reasonable time after construction has been completed.

4. Look Ahead.

The value of a solid, tight, build-to-suit lease can never be overestimated. A build-to-suit lease may start out as a form, but both parties will regret a failure to customize that form for their special construction or operating needs at the tenant's opening and operating. There will be a win-win situation when the construction proceeds smoothly and satisfactorily to completion. ■

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Gross Deals

area utilities, common area taxes and any marketing costs are included within the one number that is the base minimum rent. At General Growth Properties, that type of deal is now called a "one-bucket" deal. It captures all costs, except for tenant premises consumables (such as utilities).

The one-bucket deal is in contrast to a "two-bucket" deal. At General Growth Properties, a two-bucket deal has one number for base minimum rent and a separate number for all other costs except for premises consumables. Thus, there are two buckets: base minimum rent and another number that includes CAM, real estate tax, marketing costs, etc.

What is the purpose of a two-bucket deal? A two-bucket deal may solve a problem for both the landlord and the tenant. If accounting rules are such that rent must be straight-lined over the term of the lease, both parties may well not want one large all-inclusive gross number. In that case, a two-bucket approach would limit the straight-lining to the base rent, and not to the occupancy charge bucket. The two-bucket approach also provides a more accurate base rent from which to create a natural breakpoint.

Of course, there also are other charges that the parties may decide they want to maintain outside of the gross lease number. While utilities are one type, it could also be decided that other forms of taxes, which are not real estate or income in nature, should be separately assessed and paid for by the tenant. However, the more exceptions made, the less the deal seems like a gross deal,

In many cases, the actual modification of an existing lease form can be quite simple and easy. In a one-bucket gross deal, the landlord essentially wipes out the tenant obligation to pay *pro rata* or fixed contributions to CAM and tax expenses. The landlord may want to include the remainder of the paragraphs pertaining to those expenses, as they define what elements the expense pool contains. This becomes important because certain expenses such as personal property or rent taxes, or premises utilities, are not part of the gross deal, and their exclusion from the CAM or tax pools is made clearer by showing that they are not part of those costs pools.

Even in a two-bucket deal, where there is a separate occupancy charge, modifying the lease may be as simple as having all the typical expenses in CAM, taxes and marketing bundled together to one fixed charge on a reference page. Again, it is important to keep definitions in place so as to make clear what is, and what is not, included in that charge.

A detailed and careful review of a lease form also is important, as there may be a number of cross-references to CAM, tax and marketing charges that need to be modified or eliminated. Obvious links are in default provisions, additional rental definitions and even the general definitions provisions of the lease. However, oft-forgotten links exist in provisions relating to alternative rental structures for co-tenancy, exclusives and sales threshold reductions. It is important to make sure that if an alternative rent was based on a tenant's paying reduced rent and charges, that a revised rent structure is considered, because the tenant is not paying anything but a gross rent. This is especially critical if the tenant is paying a percent *in lieu* gross deal.

There are many benefits to a gross deal if both sides are in a position to undertake that structure. However, it is important to do one's homework, because once that structure is assumed, it will last for the term of the lease. ■

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