

## Tenant Improvement Issues in Retail Leases

**Daniel Goodwin**

Gill Elrod Ragon Owen & Sherman, P.A.  
Little Rock, Arkansas

### Introduction

When a retail business decides to move into newly leased space it usually makes improvements to implement its branding and floor plan layout strategy. These strategies may simply involve a new coat of paint or include demolition of interior walls, replacing floor coverings, installing counters, shelving and new HVAC systems. The more complex the tenant improvement plan, the more complex and numerous the legal issues raised thereby. Who owns the improvements? Who is responsible for paying for them? Who is responsible for installing and maintaining them and to what standard must they be built? These and other questions arise in connection with negotiating and documenting tenant improvement provisions in retail leases.

### Responsibility for Constructing Tenant Improvements

Obviously, tenant improvements must be constructed by either the landlord or the tenant. If the landlord is in the process of completing the center and has a fully-mobilized construction crew at the site, the landlord may be able to achieve time and cost efficiencies by using the same contractors for the tenant improvements. Some larger retailers may have construction companies who specialize in completing their premises to particular specifications all over the country. In either case, the party who does not select the contractor may have concerns about its qualifications, and most leases deal with the right of the other party to approve of the contractor employed to finish out the premises. Preferably the identity and acceptability of the contractor can be addressed in the lease. However, if that is not feasible, the parties may provide for a certain period of time in which the tenant has to notify the landlord of its proposed contractor. The tenant should require that the landlord provide approval or disapproval of the contractor within a specified period of time with silence implying consent. The landlord may negotiate to require the contractor to provide a payment and performance bond to secure completion of the work without mechanics liens. Unless the contract provides that the landlord may withhold consent in its sole and absolute discretion, its approval or disapproval of the contractor must be provided in good faith.

### Standard of Construction

The parties must also establish the standard to which the improvements will be constructed. The landlord must protect the overall safety and appearance of the center and usually insists on the right to approve the tenant's architectural plans and specifications in advance. If the plans and specifications are complete at the time of lease signing, the landlord can review and approve them prior to execution. This minimizes the risk of delays caused by disagreements over the plans at a later date. If the plans are not available at lease signing, the landlord will usually require the right to review and approve them prior to the commencement of construction. The tenant normally insists that any such review be completed within a certain time period after delivery and if no comment is received in that time then approval is deemed granted. Regardless of who builds the improvements, the responsible party is normally required to act in accordance with all federal, state and local codes, regulations and laws applicable to the project.

### Commencement and Completion of Construction

The commencement of construction, and more importantly the completion of construction, are critical issues for both the tenant and the landlord. In many retail leases, the lease (or the payment of rent) can not commence during certain "blackout" periods occurring during the year-end holidays. The rent commencement date may start when the landlord turns the premises over to the tenant or upon a certain number of days thereafter. The tenant would prefer the latter, especially, if it must construct its own improvements. If the landlord constructs the improvements, then the turnover date will often be the rent commencement date. Care must be taken in the lease to define not only the standard to which the tenant improvements must be constructed, but also the condition of the premises on the turnover date. Generally, the landlord could turn the premises over in one of three conditions: "as-is", "cold dark shell" or "vanilla shell." The first condition is self-explanatory. A "cold dark shell" is generally one without HVAC or lighting installed. A "vanilla shell" generally has all utilities, HVAC and lighting in place with drywall hung. These terms may vary from region to region or project to project and the parties should clearly define their meaning.

Regardless of the standard chosen, both parties should covenant to diligently proceed to complete their respective construction obligations in a good and workmanlike manner. The only excused delays might be for "*force majeure*" events which the parties should clearly define. These events may include construction industry problems, general economic issues or just plain "acts of God."

However, if there are no delays and a party fails to deliver their work as promised, there should be consequences. Depending on the relative bargaining power of the parties, the landlord often receives grace periods in which to deliver the premises. These delays also postpone the rent commencement date. Even in these cases, the landlord is generally required to turnover the premises by an outside delivery date. Failure to deliver the premises by the outside date often creates an option in favor of the tenant to take possession with an abatement of rent or to terminate the lease. The landlord should require the tenant to choose his remedy within a definite period of time or lose it.

### Tenant Improvement Allowance

Landlord's often offer a "tenant improvement allowance" to offset the cost of moving to a new location. The landlord recovers the cost of this allowance through the payment of higher rents. Both the landlord and tenant focus on the procedure for payment of the allowance. The lease may provide that the landlord pay the allowance at lease signing, periodically as construction of the improvements progresses or upon rent commencement. Regardless of when the landlord pays the allowance, it should insist on receiving invoices and lien waivers for the contractors who have actually performed the work. This reduces the risk of unpaid contractors filing mechanics or materialman's liens on the property. It also ensures that a certain amount of the funds are invested in the improvement of the premises.

As the real estate market has softened, some retail developers have suffered financial instability. Some tenants have discovered that as they complete their lease-required tenant improvements, the landlord can not afford to pay the allowance it promised. To prevent this risk some tenants have required the full amount of the tenant allowance to be placed in escrow with a disinterested third party.

### **Ownership of Tenant Improvements**

Ownership of the tenant improvements matters to both parties. Landlords who view the tenant improvement allowance as a rent concession which they can not fully amortize through rental payments will argue that tenant improvements should be deemed fixtures to remain on the premises after lease termination. Of course, some improvements will be of such a nature that they are not worth removing, but tenant may want to remove others, such as branded or easily removable shelving or display cases known as "trade fixtures". The parties must clearly define trade fixtures and state whether the tenant may remove them upon lease termination. If the tenant has the right to remove such trade fixtures, the landlord may require a security interest in them to secure repayment of rent and other lease obligations of the tenant.

Of course there are federal tax implications related to the ownership of the tenant improvements and the payment of the tenant improvement allowance. In general, if a landlord provides a tenant with an allowance and the landlord owns the improvements for tax purposes, a landlord can depreciate only the cost of the improvements. Those enhancements are considered real property and depreciated over a period of 39 years using the straight-line method of depreciation.

If the tenant owns the improvements for tax purposes, the landlord can depreciate the improvements over a shorter time period (i.e. over the lease term), but the tenant will be forced to treat the allowance as income and depreciate the cost of the improvements over 39 years.

Section 110 of the Internal Revenue Code generally provides that a tenant improvement allowance is not treated as income by the tenant in retail leases entered into after August 5, 1997, with terms of 15 years or less (including options, unless the rent, during such extension periods, is based on fair market value) and which constitute "qualified long term real property" as defined in Section 110. For Section 110 to apply, the allowance must be used to construct realty improvements for use in the tenant's business and cannot exceed the amount expended by the tenant for such improvements.

The tax treatment of tenant improvement allowances is complex and beyond the scope of this article. However, landlords and tenants contemplating their improvement allowance are well-advised to consult with their tax advisors on this matter.

### **Sample Lease Provisions**

Several sample lease provisions relating to tenant improvements follow.

Improvements. Landlord agrees to construct leasehold improvements in accordance with the Vanilla Box Criteria attached as Schedule \_\_\_ hereto and made a part hereof. In the event that Tenant shall be entitled to possession of the Premises during any period in which Landlord is constructing the leasehold improvements pursuant to this section, Tenant shall not unreasonably interfere with Landlord's completion of its required leasehold improvements hereunder. Notwithstanding anything contained herein to the contrary, in the event that Landlord does not complete its required leasehold improvements for Tenant on or before the Commencement Date, the Commencement Date shall be extended by the number of days following the Commencement Date until the date of completion by the Landlord. Landlord agrees to perform the work set forth on Schedule \_\_\_ and to deliver the Premises to Tenant on or before the Landlord Finish Date.

In no event shall Landlord be obligated to complete or otherwise provide any of the Tenant finish work for the Premises. Tenant shall have the right to choose the contractor to perform all tenant finish work; provided, however, that Landlord shall have approved the contractor in writing, which approval shall not be unreasonably withheld. All plans, drawings and specifications for the tenant finish work shall be approved in writing by Landlord prior to the commencement of the tenant finish work; provided, however, that any denial of such approval must be made in writing by Landlord within fifteen (15) days following the submission to Landlord of all such plans, drawings and specifications, or else such approval shall be deemed to have been given. Tenant agrees to commence remodeling of the Premises promptly upon approval by Landlord of such plans and specifications. All such remodeling must be completed prior to the Commencement Date. Upon completion of all tenant finish work, Tenant shall submit to Landlord a written invoice accompanied by waivers of all contractors' and subcontractors' mechanics' and materialmen's liens. If Tenant submits lien waivers from all contractors and subcontractors providing work on or materials to the Premises, then Landlord shall pay to Tenant the Construction Allowance.

For the purpose of performing its obligations hereunder and for the purpose of installing its fixtures and other equipment, Tenant will be permitted to enter the Premises thirty (30) days prior to the Commencement Date, on condition that (i) Tenant's activities are conducted in such a manner so as not to unreasonably interfere with Landlord's shopping center activities, and (ii) Tenant shall, at its own expense, remove from the Premises and from the Shopping Center in its entirety all trash which may accumulate in connection with Tenant's activities. It is understood and agreed that during said thirty (30) day period, Tenant shall perform all duties and obligations imposed by this Lease, saving and excepting only the obligation to pay Rental.

Effect of Opening for Business. By opening for business, Tenant shall be deemed to have:

- (a) Accepted the Premises,
- (b) Acknowledged that the same are in condition called for hereunder, and
- (c) Agreed that the obligations of Landlord imposed hereunder have been fully performed.

Mechanic's Liens. No work performed by Tenant pursuant to this Lease, whether in the nature of erection, construction, alteration or repair, shall be deemed to be for the immediate use and benefit of Landlord so that no mechanic's or other lien shall be allowed against the estate of Landlord by reason of any consent given by Landlord to Tenant to improve the Premises. Tenant shall pay promptly all persons furnishing labor or materials with respect to any work performed by Tenant or its contractor or subcontractors on or about the Premises. In the event any mechanic's or other lien shall at any time be filed against the Premises by reason of work, labor, services or materials performed or furnished, or alleged to have been performed or furnished, to Tenant or to anyone holding the Premises through or under Tenant, Tenant shall forthwith cause the same to be discharged of record or bonded to the satisfaction of Landlord. If Tenant shall fail to cause such lien forthwith to be so discharged or bonded after being notified of the filing thereof, then, in addition to any other right or remedy of Landlord, Landlord may bond or discharge the same by paying the amount claimed to be due, and the amount so paid by Landlord including reasonable attorney's fees incurred by Landlord either defending against such lien or in procuring the discharge of such lien, together with interest thereon at the Default Rate, shall be due and payable immediately by Tenant to Landlord as Additional Rental.

Tenant's Trade Fixtures. Landlord shall have, and Tenant hereby grants, a Landlord's lien and a security interest in any furnishings, equipment, fixtures, inventory, accounts receivable or other personal property of any kind belonging to Tenant, or the equity of Tenant therein, on the Premises. The security interest is granted for the purpose of securing the payment of rent, other charges, assessments, costs specified in Section \_\_\_\_, penalties and damages herein covenanted, to be paid by Tenant hereunder. Upon Tenant's default or breach of any covenants of this Lease, Landlord shall have all the remedies available under the laws of the State, including, but not limited to, the right to take possession of the above mentioned property, without liability for trespass or conversion, and sell the same at public or private sale, after giving Tenant reasonable notice at Tenant's last known address of the time and place of any public sale, or of the time after which any private sale is to be made, at which sale the Landlord or its assigns may purchase it. The proceeds from any such disposition, less any and all expenses conducted with the taking of possession, holding and selling of the property, shall be applied as a credit against the indebtedness secured by the security interest granted in this paragraph. Any surplus shall be paid to Tenant or as otherwise required by law; Tenant shall pay any deficiencies forthwith. Upon request by Landlord, Tenant agrees to execute and deliver to the Landlord a financing statement in form sufficient to perfect the security interest of Landlord in the aforementioned property and proceeds thereof under the provisions of applicable law. Any applicable statutory lien for rent is not herein waived, the security interest herein granted being in addition and supplementary thereto.

Surrender. Tenant will surrender the Premises at the expiration of the Term, or at such other time as it may vacate the Premises, in as good condition as when received or as they may be put during the Term by mutual agreement of the parties hereto, except depreciation caused by ordinary wear and tear, damage by Casualty (other than such damage by Casualty which is caused by the concessionaires, officers, employees, contractors, licensees or invitees of Tenant), unavoidable accident or Act of God. All alterations, additions, leasehold improvements, and fixtures upon the Premises, along with any replacements thereof or additions thereto, including but not limited to any heating, ventilation, and air-conditioning systems, shall become the property of Landlord and shall remain upon, and be surrendered with, the Premises as a part thereof upon the termination or conclusion of this Lease, without compensation to Tenant. Notwithstanding anything in this Section to the contrary, on or before the day Tenant surrenders the Premises, Tenant shall remove all of its trade fixtures from the Premises. Tenant shall repair any damage caused by any such removal. Notwithstanding the foregoing provisions, if Tenant shall fail to remove its trade fixtures, Landlord may effect such removal for and at the expense of Tenant and Tenant shall thereafter reimburse Landlord upon request therefor.

**Daniel Goodwin** is a shareholder and director of Gill Elrod Ragon Owen & Sherman, P.A., Little Rock, Arkansas, and is member of the firm's Real Estate Development Group.