Build-to-Suit Leases: A Construction Contract and a Lease Merged into One

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One of the hybrids in real estate practice is a build-to-suit lease. It is both a construction contract and a lease combined into one document. A practitioner must focus both on issues arising in lease negotiations and on construction contract issues when drafting and negotiating a build-to-suit lease. This article will address the construction-related issues of build-to-suit leases.

What Is a Build-to-Suit Lease?

A “build-to-suit” lease has various definitions. The simplest definition is any lease that references some construction to meet the tenant’s requirements. This construction can range from adding minor tenant finish items to a general business office to the full design and construction of a new building particularly suited to the tenant’s business needs. Some examples of leases with a build-to-suit component (and varying levels of complexity) include minor building renovations, major renovations such as moving walls or expanding the premises, tenant finish of a shell space, cookie-cutter type construction of a standard building, such as a chain retail store or restaurant, and architectural design and construction of a special use building optimized for a particular site such as a manufacturing plant, corporate campus, or a one-of-a-kind architecturally significant office.

Minor construction on an existing building is typically handled by adding a simple work letter to a standard lease agreement. Typically, these work letters become longer and more detailed as the level of construction increases. For a full design and construction lease, the work letter can approach the complexity of a full construction contract. In effect, the parties are entering into two related transactions. The tenant is contracting with the landlord for the construction of a significant building and is at the same time entering into a transaction to lease the newly constructed building, usually for a substantial period of time. Construction concepts also tend to become more integrated into the actual lease document (as opposed to the work letter) as the construction becomes more integral to the transaction.

This article focuses on leases of new buildings to be designed and constructed under the lease. Transactions of this type necessarily involve numerous aspects of both a lease and a construction contract. References to build-to-suit leases in this article will refer to ground-up construction projects and may or may not apply to leases requiring lesser levels of construction.
**Typical Candidates for Build-to-Suit Projects**

Various types of landlords and tenants participate in build-to-suit lease transactions. Although any type of tenant may want a build-to-suit facility, a typical build-to-suit tenant requires a specialized building not readily available on the market. An example is a chain retailer or restaurant that has a standard, distinctive model used for many or all of its facilities. Amazon, for example, requires its landlords to design and build facilities in accordance with an extremely specific set of specifications designed for maximum efficiency and Amazon’s particular business needs. Certain manufacturing tenants may need a specific layout to facilitate an optimal manufacturing process. The tenant may have various related businesses that may or may not all have a presence at each of the tenant’s facilities. A tenant may have selected a unique site. The tenant may wish to have an architecturally unique building or meet certain sustainability or energy efficiency standards.

A build-to-suit landlord often has both internal construction and property management divisions specializing in build-to-suit leasing. These companies may hold the completed building indefinitely or flip the property to a more traditional investor landlord following completion of construction. Alternatively, large developers may offer build-to-suit services for pad sites or other outbuildings in the commercial centers they develop. Commercial landlords may do an occasional build-to-suit project, either because of a relationship with an existing client or because it is the most expedient way to use a site held for development.

**Site Selection**

Sites for build-to-suit projects are selected in various ways. The following alternatives are some of the more common situations: a tenant often will select a new commercial development and then negotiate with the developer to determine whether the tenant’s building will be developed on a buy-own or build-to-suit basis; the tenant may have done its own site search and selected a site advertised for a build-to-suit lease; the tenant may publish a request for proposals to various specialized build-to-suit developers, who may then each provide a proposal for a site selected by the developer; the tenant may select a build-to-suit developer and then work in partnership with the developer to locate an appropriate site for the project; or the tenant may select a site and then contact various build-to-suit developers for proposals to acquire and develop the site.

**Typical Characteristics of Build-to-Suit Leases**

Although the length of the term of a build-to-suit lease varies from project to project, for the most part these leases have very long terms, often 10 to 20 years or longer. The more specialized the project, the more important it is to the landlord that the lease term be long enough to fully amortize the landlord’s investment in the property. Very specialized properties may have little value to any party other than the original tenant.

If the project is basically an off-balance sheet financing, the lease is likely to have characteristics of a “bond lease” (in which the landlord sits back and collects rent-like interest payments on a bond) or a “hell-or-high-water” lease (as in “the rent gets paid come hell or high water”). These leases typically have a long term, the tenant is responsible for all or nearly all building management and operation, and virtually nothing will interrupt the rent flow to the landlord. The tenant will be responsible for all
repairs and maintenance, will insure the building, and may even be responsible for restoration. There is often no abatement of rent for a casualty or other force majeure event. In return, the tenant will often require the ability to freely alter or expand the building and to assign the lease.

**Documenting the Construction Aspect**

As noted above, construction terms can be contained in a work letter, included in the body of the lease, or some combination of both methods may be employed. Ultimately, the decision on whether to include the provisions in a work letter or in the body of the lease will depend on the size and complexity of the project. For significant build-to-suit projects, some elements of the construction project will be included in the body of the lease, but the bulk of the construction terms will be contained in a separate work letter or construction agreement, which is attached as an exhibit to the lease and signed simultaneously with the lease.

Construction information that may be included in the lease documentation includes the proposed site plan, proposed interior schematic drawings, exterior renderings, a detailed pro-forma construction budget, project specifications, a list of any tenant-provided construction, the construction schedule, and other construction-related documents.

**Core Concerns of Each Party**

As in any construction project, the landlord and the tenant in a build-to-suit lease are each focused on having the work completed (1) on time, (2) within the allocated budget, and (3) properly, in accordance with the construction plans and specifications. When the landlord performs the work, rent payments typically will not commence until after the work has been *substantially completed* (more on that standard later). The landlord therefore should establish a schedule for the construction process and make sure its contractor closely adheres to that schedule.

Also of fundamental importance to the landlord is keeping the construction project within budget. If the landlord has agreed to deliver a turnkey project at its sole cost (without any tenant reimbursement), a failure to stay within budget will hurt the landlord’s economics. If the tenant is liable for cost overages above the budgeted amount, a cost overrun will result in an unhappy tenant, which is not a particularly good way to start what hopefully will be a long-term relationship between the landlord and the tenant. If the project is significantly over budget, the tenant could resort to litigation either to terminate the lease or to attempt to charge the landlord for the overages because of negligent management of the project.

Likewise, the landlord wants the work properly performed in accordance with the plans and specifications. Not only will improperly performed work potentially lead to an unhappy tenant, but the landlord also could suffer lost rent while defects are being repaired.

For the tenant, its business needs may require it to open the location for normal business operations by a date certain. The tenant may have an existing lease that is expiring, requiring the tenant to relocate by a certain date or face holdover rent. Retail tenants may want to be open before the holiday season, and industrial tenants may have contractual deadlines to deliver products or services.
Few issues are of greater importance to the tenant in a build-to-suit lease than ensuring the construction fits the tenant’s needs and complies with applicable laws. Smart tenants spend an extraordinary amount of time and effort in the planning stages of a project and involve important stakeholders to try to ensure that the ultimate project suits the tenant’s needs. When interviewing prospective landlords for a build-to-suit lease, sophisticated tenants often present a detailed set of specifications, which often is attached as an exhibit to the lease. This is especially true of national retailers and restaurants that have standard building models.

The tenant will want to limit its liability for costs and cost overruns on the project. Ideally, from a tenant’s perspective, the landlord will be liable for cost overruns. If the tenant is forced to contribute an amount to the build-out, the lease from the tenant’s perspective should set forth that specific amount. The tenant’s argument to the landlord (when the landlord is responsible for the build-out) is that insofar as the landlord handles the construction process and hires the general contractor to perform the work, the landlord is in a better position to control costs than the tenant. Likewise, to the extent excess costs result from unknown conditions, the landlord, as the property owner, is in a better position to have known about those conditions.

Change orders also may result in cost increases. Build-to-suit leases typically provide that the tenant shall pay for the additional costs of any change orders the tenant requests either up-front or at an amortized rate over the term of the lease. If a tenant allowance is obtained for the improvements, the tenant should add language that it is liable for the cost of change orders only to the extent the change order causes the project cost to exceed the amount of the allowance. From the landlord’s perspective, although it may desire to reasonably accommodate the tenant’s change order requests, it does not want to delay substantial completion and the start of rent payments. Nor does it want to bear any cost of a change order. The landlord may consider adding language stating that, if a tenant change order delays the completion of the improvements beyond the targeted completion date, the rent commencement date shall nonetheless be the date it would have been had the change order not been accepted.

The tenant needs to ensure the site works for its business needs. Because of the typical long-term nature of a build-to-suit lease, the tenant’s due diligence can be similar to that performed by a property purchaser. The larger the construction project and the longer the initial term of the lease, the greater probability the tenant will need to perform its own geotechnical study and environmental testing. The tenant will want to examine title to and the zoning of the property and potentially procure leasehold title insurance. The tenant also will need to investigate access rights and infrastructure.

Landlords also need to perform due diligence, particularly when they are acquiring a site to develop. For example, the landlord needs to know whether rezoning or resubdivision will be needed or whether there are issues with infrastructure or utilities. See Marie Moore, *Avoiding the “Gotcha”—Build-to-Suit Construction Issues*, 8 Retail L. Strategist, no. 5, 2008, at 1, 3.

If the landlord needs to obtain zoning approvals or other rights in order to develop the property as planned, the landlord should include a provision permitting it to terminate the lease without liability to the tenant if such approvals are denied or if no decision is made by the governing jurisdiction within
some set period. Id. Likewise, the tenant may want a termination right if its due diligence shows the site is not satisfactory or if all necessary permits, rezoning, or other required or desired approvals are not obtained by a predetermined date. Id. When the landlord is acquiring the property, then the party's termination rights under the lease should be exercised before the landlord's termination date under the purchase agreement. Id.

Scope of Work and Responsibilities of Each Party

Landlord Design and Construction. In many instances, a build-to-suit project is designed and built by the landlord, often a specialized build-to-suit developer that maintains a full construction division in addition to a leasing division. Larger build-to-suit developers will have in-house design capabilities. The vast majority of tenants will never build more than one or two buildings. Even those that build a building every few years may not have the experience or knowledge to play a significant role in the design and construction phase of the project. The experienced build-to-suit firm or developer, on the other hand, deals with these issues regularly and has an experienced staff of professionals to guide the tenant through the construction process. Moreover, although a building may be customized to some extent, many build-to-suit projects involve fairly standard office or retail buildings. In such cases, the tenant may not need to have significant involvement in the project.

Even when the tenant has a reasonable amount of experience in construction, the landlord will likely have various reasons to want to minimize tenant involvement in the construction process. First and foremost, the landlord is investing a large amount of capital in the project and will own the completed project. Clearly, the landlord will not want to risk obtaining a poorly designed or constructed building. If the project is part of a larger development already constructed by the developer, the developer will already have design and construction teams in place that are familiar with the overall project. In such cases, it is more cost-effective to have those teams handle the new building rather than to bring in new teams unfamiliar with the project. When the project is being financed by the developer, the developer’s lender will not permit construction to be performed by anyone other than the developer.

Tenant Construction of Specialty Items. Although the standard landlord design and build model will be effective in most cases, if the project includes trade fixtures or other elements that are either highly specialized or that the landlord does not believe will add reasonable value to the new building, the parties may agree that the tenant will be responsible for these specialized portions of the project. Even absent truly specialized tenant requirements, the tenant may assume responsibility for installation of voice and data equipment and security systems because of security concerns and to allow communication with the tenant’s other locations.

If the tenant’s business requires specialized equipment or if the installation of the equipment involves specialized knowledge, the tenant may take a larger role in the construction. In a restaurant, the tenant can either specify that the contractor will use specific equipment or take responsibility itself for installation of kitchen equipment. A high-tech company might retain responsibility for clean rooms. Some industrial installations can involve trade secrets the tenant will not want to share with the developer. All of these situations lend themselves to the tenant handling specific parts of the building finish after the developer has completed the basic construction. In such cases, the lease should clearly delineate the
construction responsibilities, especially the responsibility for preparing utilities or surfaces to receive the tenant’s equipment. In a manufacturing plant, for example, drawings should show all electrical features, drains, water supply, gas lines, and so on and delineate who is responsible for hooking up the equipment to the required utilities.

**Tenant Design, Landlord Construction.** It is not unusual for the tenant to be responsible for the design phase of the project and the landlord to handle the construction, especially for large tenants that own tens or even hundreds of facilities around the country. The tenant’s design responsibilities can include the entire design or providing the landlord with schematic drawings and then having the landlord’s architect prepare the final construction documents. This is common in a number of situations. Probably the most common situation would be when the tenant has a standard design, especially for a freestanding restaurant or retail location. If the tenant has already constructed similar buildings on numerous occasions, the tenant may be able to reuse the existing plans (subject to any copyright limitations) after modifying them to account for site conditions and any differences in local code and development requirements. The same also could apply to any standard building used in the landlord’s business such as a warehouse or distribution center.

Another option is for the tenant to perform the basic design work in advance and include the design in its bid package or request for proposal for the proposed project. This approach can benefit the tenant in both time savings and by obtaining bids that are more easily compared.

**Tenant Design and Construction (Paid by Landlord).** Although rare, in some circumstances the tenant is fully responsible for the design and construction of the project, which is funded by the landlord. This is basically an alternative to a sale-leaseback transaction. Typically, this would be seen only in projects for very large tenants with significant construction experience. This approach is also useful in certain international projects in countries where foreign companies are not permitted to own real estate.

**Design Issues**

Another issue to address in build-to-suit leases is at what time construction drawings are prepared. This issue presents a catch-22. On the one hand, no one wants to spend money on construction plans and specifications before the deal is final, but, on the other hand, until those drawings are prepared and sent to contractors for bid, the construction costs for the project will not be fully known, making it difficult for either party to commit to the project. The parties therefore are basing their construction costs and the tenant allowance negotiations on educated guesses.

In addition to the cost issue, it may not be practical from a timing standpoint for those drawings to be done by the time the lease is ready to be signed. When the drawings are not done by the time of lease execution, the lease needs to set forth a process and deadlines for the preparation and approval of the drawings. Those deadlines need to fit within the overall construction schedule for the project. The lease often sets a deadline for the delivery of drawings to the other party by the party having those drawings prepared, followed by a specific time frame within which the other party needs to approve, give comments on, or reject (with specific reasons) the drawings. The lease should specify the consequences of a
party’s failure to respond by the deadline—perhaps a deemed approval. The schedule needs to allow suf-
ficient time for back and forth so both parties are satisfied with the drawings, the drawings can be sent 
out for bid, and any desired adjustments can be made to the drawings after those bids are received. To 
the extent the drawings and specifications show materials or other items having long lead times, the 
schedule will need to allow for those long lead items or the plans and specifications will need to be 
adjusted accordingly.

As Marie Moore wrote in her article, the parties can consider inserting a termination right into the lease 
if they cannot agree on final detailed plans. She also recognized that such a termination right creates an 
untenable position for a landlord that has acquired land for the build-to-suit lease. Accordingly, she 
rightly recommends that termination because of failure to agree on plans not be allowed after the land-
lord’s right to terminate the purchase agreement has expired.

The responsibility for preparation of the construction drawings depends on the circumstances. If the 
tenant is a specialized user or a large entity that does numerous construction projects each year or has 
multiple similar locations, the tenant may prefer to prepare or have prepared the drawings by an archi-
tect familiar with tenant’s business and layouts. Conversely, if the landlord is a design-build contractor 
with internal designers or if the tenant does not have internal experience with construction projects, the 
landlord likely will push to keep the design process in house.

The lease also should address the cost of preparation of the plans. The landlord can allocate a portion 
of the tenant allowance or a specific tenant allowance for the preparation of those drawings and require 
the tenant to be liable for any additional cost in the preparation of the drawings. If the drawings are pre-
pared before lease execution, the tenant will typically pay or reimburse the landlord for the cost of the 
preparation of those drawings. Such advance preparation, however, may benefit the tenant financially, 
as the detailed drawings—and any contractor bids based on those drawings—may give the tenant lever-
age to argue for an increased allowance.

If the tenant is sure it will do the project and is bidding the project out to multiple parties, it may pre-
pare full plans and specifications in advance at its own cost in an effort to obtain the most accurate 
rental cost from the prospective landlords bidding for the lease.

**Contractor Selection**

If the landlord is in the construction business or has a construction subsidiary, it often will insist 
on—and part of its value-add may be—serving as the contractor. In other circumstances, the selection of 
the contractor is another item for negotiation.

Some tenants have contractors that have performed multiple build-outs and understand and work well 
with them. On the other hand, a landlord may want to control which contractors perform work in (or 
construct on) its properties. When the contractor has not been selected at the time of the lease execu-
tion, the lease may set forth a process for that selection. The lease can specify that the landlord shall
send the construction drawings out to a minimum number of firms for bid, and the tenant shall be enti-
tled to nominate one or more bidders, or select or have approval rights over the winning bid, particu-
larly if the tenant has liability for construction costs in excess of the allowance.

The negotiation of the construction contract—and the degree to which each party wants approval rights over a construction contract between the other lease party and a third-party contractor—often depends on the circumstances. The three most common choices of construction contracts are a fixed cost or stipu-
lated sum contract (in which the work is performed for a set price), a cost-plus contract (in which the contractor bills the landlord for the contractor’s costs to perform the construction work plus an agreed amount for the contractor’s profit), or a guaranteed maximum price (GMP) contract (which is a hybrid). Under a GMP contract, the contractor bills the landlord for the contractor’s costs, plus a profit percentage, but agrees not to exceed a certain designated amount. If the tenant has liability for excess costs above an allowance, it may want to confirm the contract is for a stipulated sum or a GMP. Often the total costs under a cost-plus contract are lower than under a stipulated sum or GMP contract because the contractor needs to build in less of a contingency; however, the tenant may prefer the certainty of a fixed price or not-to-exceed price.

If the landlord is a pure investor, the situation may be more akin to a sale-leaseback in which the tenant selects the contractor, negotiates the construction contract, and handles most of the project manage-
ment, even though the contract is in the landlord’s name. Generally, in such a situation, the landlord will have someone review the project but otherwise takes a fairly hands-off approach. This is most com-
mon with a Fortune 500 or similar-sized tenant with the capability to do the project independently but that wishes to structure the transaction as a lease for financial reasons.

### Work Schedule, Including Pertinent Deadlines, Phased Completion, Substantial Completion, and Final Completion

**Schedule**

Completing the work on schedule is of great importance to both parties. Generally, the landlord will not receive any rent until the building is properly completed. The tenant has business projections, customer obligations, and often deadlines to vacate its existing facilities that may be adversely affected by late completion.

Although no one wants a construction project to be delayed, in practice, delayed completion happens. The parties need to work together to ensure the project is completed on time. Each party should appoint a project manager who can decide on day-to-day construction issues. The tenant must provide prompt responses to landlord inquiries and should regularly inspect the project to ensure it is being constructed in accordance with the tenant’s requirements.

Changes in the work are a major cause of delays. The more complete the project plans are before the start of construction, the better. The tenant should have a well-developed set of specifications for the project to ensure time is not lost in selecting finishes or because of the unavailability of materials. When
the landlord is building the project, it should use good project management practices to anticipate potential delays in all areas of construction and take appropriate actions to avoid or minimize such delays.

**Force Majeure and Other Excused Delays**

No matter how carefully a project is planned, it is always possible that the project will be delayed by force majeure. Most commonly, force majeure will be caused by natural disasters such as hurricanes and windstorms, tornados, earthquakes, wild fires, and freezing weather; however, any number of events can be defined as force majeure under a typical build-to-suit lease.

Although generally nothing can be done to avoid a force majeure event, the parties should carefully consider what types of events would excuse the landlord’s performance. Some force majeure clauses list very specific events such as war, natural disasters, strikes, and terrorism. Other clauses are very general in nature; for example, referring to any cause outside of landlord’s reasonable control. The more specific the clause, the more limited the types of events that can relieve the landlord of its obligation to complete the work by the commencement date. If the landlord is using an outside construction contractor, the landlord should ensure that the force majeure clause in the construction contract mirrors the clause in the lease. In addition to natural disasters, any unusual weather can delay a project if it occurs before the shell construction is complete or when final exterior work is being done. Leases and related construction contracts may note that above-average rainfall or early freezes or snowfall can constitute an excused delay.

Besides typical force majeure events, the lease may provide that certain other matters will constitute “excused delays,” that is, delays for which the landlord is entitled to an extension of the completion date. These are typically construction-related circumstances and can include delays in issuing building permits or other government approvals for reasons outside of the landlord’s control, discovery of hazardous materials at the project site, or discovery of endangered species or historical relics at the site.

From the tenant’s standpoint, it will want to receive notice shortly after the commencement of a force majeure event. The tenant should consider adding language to the lease to the effect that a force majeure event will not extend the completion deadline unless the landlord has given the tenant notice a certain number of days after the start of the event.

**Landlord and Tenant Delay**

Delays in construction generally will be attributed to the landlord, the tenant, or to force majeure or other excused delays. A build-to-suit lease typically includes a detailed clause describing what types of delays will be attributed to the tenant and therefore allow the landlord additional time to complete the project. Tenant delays can be defined in great detail or simply as delays caused by the tenant, such as failure to timely respond to requests for approval. Some items that can be specified as tenant delays include failure to timely provide information required to prepare construction documents; failure to timely approve construction documents; requests for special order materials, finishes, or equipment; changes in the work requested by tenant; and delays caused by the tenant’s separate contractors.
The tenant should try to curtail the landlord's ability to extend the schedule because of a supposed tenant delay. The tenant can ask for notice and cure rights, for example. As with force majeure, the tenant can try to require a notice to the tenant of an alleged event within a certain number of days before that event (or non-occurrence) constitutes a tenant delay.

**Change Orders**

Changes in the work are probably the most common cause of delays in completion. Although few projects are constructed without change orders, it is important to minimize change orders through a thorough initial design and by establishing institutional controls on the change order process.

It is recommended that the landlord and tenant each appoint a single person and an alternative to approve change orders. If numerous stakeholders within the tenant’s organization can all request (or approve) changes in the work, major delays in the project are all but inevitable. If all changes are routed through the project manager and an internal procedure is established to review requested change orders, it is far more likely that the project will be completed on time and within budget.

Change orders take time not only because of the additional construction required but also because of the process of initiating and approving the change order. When the tenant decides that it might like to have a slightly different layout or a change in entry tile, the contractor needs to devote time to researching the change, determining what effect the change has on the existing work, pricing the materials and determining their availability, and then writing up a proposal for the change order. The tenant then needs to review the landlord’s response and obtain its internal approvals for the additional cost and time.

**Substantial Completion**

A typical definition of substantial completion is “the stage in the progress of the Work when the Work or designated portion thereof is sufficiently complete in accordance with the Contract Documents so that the Owner can occupy or utilize the Work for its intended use.” American Institute of Architects, AIA® Document A-201™—2007 General Conditions of the Contract for Construction§ 9.8.1. Under AIA contracts, this is determined by the project architect. With the landlord anxious to start receiving rent and the tenant determined to have its new building completed exactly as it has envisioned it, the parties can dispute when the project is substantially complete. What exactly is sufficiently complete? Who employs the architect that makes the decision? It is important to have clear directions in the lease stating who determines substantial completion and what conditions constitute substantial completion. A tenant may wish to note specific items that it expects to be complete as a condition to substantial completion, especially if the building was intended to perform some special purpose.

**Who Determines Substantial Completion?** Often the parties do not give this question much consideration, and they end up negotiating whether the building is substantially complete. Often the lease is silent on how substantial completion is defined and determined, and many construction contracts use the standard AIA® language, even though the architect may not provide construction phase services. A savvy tenant will try to use language similar to the AIA® standard.
but note that substantial completion is determined by the tenant, or by the tenant in the tenant’s reasonable discretion. The tenant can argue that as the property is being constructed to the tenant’s requirements, only the tenant truly knows when the property can be used for its intended purpose.

Obviously, the landlord will not want the tenant to have the ability to delay payment of rent until every last bit of construction is completed. The landlord will typically try to control the completion date, either by providing that the landlord will determine when the project is substantially complete or by having the landlord’s architect determine completion. It is often best to state specific requirements for substantial completion. An example of a tenant clause defining substantial completion is as follows:

Notwithstanding anything herein contained, the Improvements shall not be considered complete until (i) the Tenant has determined it can occupy or utilize the Improvements for their intended use, (ii) all that remains to be done is to correct or repair defective or non-conforming work or other minor punch list items, (iii) all systems and facilities included in the Improvements and necessary for the Tenant’s occupancy of the Improvements have been installed and are in good operating order and condition, and (iv) the Landlord has obtained all necessary governmental and other permits and approvals of the Improvements (in final form) to permit lawful occupancy of the Premises for Tenant’s intended use. The punch list may include only minor work capable of being completed within thirty (30) calendar days.

Certificate of Substantial Completion. Whether or not an AIA® contract is used for the construction, the parties may use the standard AIA® Certificate of Substantial Completion, AIA® Document G704™—2000, the language of which is similar to that contained in the standard AIA® construction contracts. Although this is not a bad definition, by expanding on it as noted above, the tenant receives some additional certainty about what is meant by “sufficiently complete . . . [to] utilize the Work for its intended use.” Although one might expect that to mean that all utilities are in place, all systems are operational, and all permits have been issued, it is better to state these items clearly than to rely on the landlord’s architect having the same understanding.

Ready to Use for Its Intended Use. The ultimate question in determining substantial completion is whether the premises are ready to be used for their intended purpose. This should generally be clear for a typical office, warehouse, or retail store. A restaurant or other food service venue might be a bit more difficult to determine because of the need to ensure that health department requirements have been met and that the equipment (if it is to be supplied by the landlord) is fully operational. It can be difficult, however, to agree on whether the property is ready to use if it will be used for technical, industrial, or manufacturing purposes. In these cases, the tenant should either insist on making the determination or add any special performance conditions to the substantial completion definition. For example, for delicate manufacturing work, electrical power often must achieve a specific reliability factor to avoid causing large amounts of waste. Similarly, there must be sufficient utility capacity for the tenant’s requirements.
**Final Inspection and Punch List**

When the landlord’s contractor believes the project is substantially complete, the contractor will contact the landlord and schedule an inspection to determine substantial completion. This is normally done by the contractor, the landlord, and the project architect, but, in a build-to-suit situation, the tenant also should be involved. Both parties will want to have a consistent punch list and a consistent date of substantial completion, and a way to facilitate this is by having all parties do a joint walk-through inspection. If the tenant does not have internal construction personnel, the tenant can hire its own architect or consultant to participate in the substantial completion review and preparation of the punch list. For a large project, the parties may wish to inspect the property over a period of time and then meet to coordinate their respective preliminary punch lists.

The punch list should include only items that will not adversely affect the tenant’s ability to use the improvements for their intended purpose. Accordingly, punch list work should be fairly minor items. Because the tenant will not want construction workers disrupting its activities for any longer than necessary, it is good practice to require that all punch list items be completed within 30 or 60 days. Once the parties have all agreed on the remaining work to be completed, the punch list is attached to a certificate of substantial completion (either one drafted by the parties or the standard AIA® Document G704™—2000), which is signed by the landlord and the contractor. At the same time, the landlord and the tenant sign a commencement certificate confirming the commencement date for the lease term.

The standard certificate of substantial completion specifically states “[t]he failure to include any items on such list does not alter the responsibility of the Contractor to complete all Work in accordance with the Contract Documents.” The tenant should insist on similar language in the commencement certificate or any related punch list. Although landlord forms often state the premises are accepted “AS IS” other than punch list items on signing the commencement certificate, the commencement certificate should include language identical to that contained in the standard certificate of completion set forth above.

**Fixturing Period**

Depending on allocation of construction responsibilities and the tenant’s business, the tenant may need to complete considerable additional construction following substantial completion of the building to ready the building for the tenant’s business operations. During this period the tenant may install trade fixtures, voice and data systems, security systems, and other specialized tenant improvements. The landlord and tenant may negotiate a rent-free or reduced-rent fixturing period to allow the tenant to complete the final tenant finish items. A typical fixturing period might grant the tenant one-month free base rent to complete its fit out with the tenant being responsible for all other expenses, such as utilities, maintenance, and insurance.

**Ramifications for Late Delivery or Default**

For the many reasons discussed above, even when all of the parties have worked together throughout the process to ensure that the construction is completed as quickly as possible, construction delays are still quite common. If the tenant has timed its move to the new facility to coincide with the termination
of its existing lease, the tenant may end up in a holdover under its existing lease. Depending on the particular circumstances, such a holdover can be difficult and costly to the tenant. Assuming the tenant did not cause the delay, what alternatives does the tenant have when a delay occurs?

**Tenant Holdovers Under the Existing Lease**

Most significant leases contain some kind of holdover provision. A tenant-friendly provision will provide that a holdover will create a month-to-month tenancy at the same rate as was in effect at the end of the term. A landlord-friendly provision might provide that the holdover tenant is a tenant at sufferance at a rate of some multiple of the rent at the end of the term, such as 200% or more. Obviously, a lengthy stay at such a holdover rent will quickly become painful for the tenant.

If a tenant remains in possession at the end of a lease term and continues to pay rent, and the landlord accepts the rent, the holdover may be found to be an extension of the lease. If the lease contains an extension option that does not specifically require written exercise, the holdover may be considered an exercise of an extension option unless the tenant clearly notifies the landlord that it does not intend to extend the lease. Even when written renewal is required, it is possible a lengthy holdover could be determined to waive the requirement of written notice. Some leases may contain evergreen renewal clauses providing that the lease will automatically be extended at the end of each term unless one of the parties notifies the other that it does not intend to extend the term.

It is possible that the state in question has a statute abolishing holdover tenancies and substituting some other tenancy, typically from month to month or from year to year. See Kan. Stat. Ann. § 58-2502 (“[w]hen premises are let for one or more years, and the tenant with the assent of the landlord continues to occupy the premises after the expiration of the term, such tenant shall be deemed to be a tenant from year to year.”); Conn. Gen. Stat. § 47a-3d (“[h]olding over by any lessee, after the expiration of the term of his lease, shall not be evidence of any agreement for a further lease. Parol leases of lands or tenements reserving a monthly rent and in which the time of their termination is not agreed on shall be construed to be leases for one month only”). Absent such a statute, the holdover will likely still form a periodic tenancy under state common law. Typically, the term of the common law periodic tenancy created by the holdover will be equal to the rent payment period, but note that if the rent is stated as an annual rent paid in installments, the tenancy may still be considered a year-to-year tenancy.

The renewal or periodic tenancy can be good or bad for the tenant, depending on the length of the tenancy. A month-to-month tenancy may afford the tenant the time needed for construction to be completed and for the tenant to relocate. On the other hand, a periodic tenancy for an additional year or an extension for one or even several years may lock the tenant into payment of rent for a property it neither wants nor needs. Accordingly, it is extremely important for the tenant to carefully review its lease and discuss options with its current landlord as soon as it suspects the premises may not be completed on time.

**Effect of Construction Delay on the New Lease**

As previously discussed, it is common for build-to-suit leases to allocate fault for construction delays among three categories: landlord delays, tenant delays, and delays for which neither party is at fault. Often significant delays will be some combination of all three. In the event of a tenant delay, the build-
to-suit lease will often provide for no adjustment of the lease terms, such that the tenant will commence payment of rent on the date the rent would have commenced absent the tenant delay. For delay not caused by either party—typically force majeure delays—the tenant will not be required to pay rent early, but it will receive no assistance with any costs it might incur under its existing lease for failure to vacate the premises or for relocating to temporary space.

If the construction delay is because of the fault of the landlord, including delays caused by the landlord’s general contractor, then a well-represented tenant should have some type of remedies included in the lease. Most basically, the rent would not commence in the new space until the building is substantially complete. In recognition of the damages suffered by the tenant because of the landlord’s delay, the lease may provide for some amount of rent abatement for each day of delay. This may be from one-half day to two days rent credit for each day of delay by the landlord. Alternatively, there may be a provision for the landlord to pay the tenant’s costs for holdover rent and similar expenses or for temporary space during the delay. Typically, the landlord will want to limit damages to a set amount, such as a day’s rent. Most importantly, the landlord will want to avoid liability for consequential damages, such as the tenant’s lost business.

Depending on the circumstances, the tenant also may want the right to terminate the lease if the building is not completed on time. The landlord will strongly resist this, especially if the premises are of a nonstandard design. A delay would generally need to be either early in the project or for an extremely long period for there to be much likelihood that the landlord will agree to permit termination. Termination would most commonly be available if the landlord is unable to obtain basic rights required for the project, such as rezoning or a building permit, or if the landlord is unable to complete the purchase of the proposed project site.

**Warranties**

From the tenant’s standpoint, when the landlord is responsible for the build-out, the warranties on that work should be set forth in the lease. A knowledgeable tenant will require numerous different construction-related warranties on a build-to-suit lease. For example, the tenant will want the landlord to warrant that the work will comply with the plans and specifications and construction drawings as well as all relevant construction and zoning codes (the landlord may wish to add “in all material respects”). In addition, the tenant will want the landlord to warrant that when the build-out is completed, all mechanical, electrical, plumbing, HVAC, and all other systems serving the premises shall be connected to the premises and in good working order.

The tenant should require a landlord warranty that the work shall be free from any construction defects. The landlord’s response to these tenant warranty requests often is that the landlord shall not provide an independent warranty of its own, but rather shall assign to the tenant the construction warranty that the landlord is receiving from the general contractor on the work. From a tenant’s standpoint, that response is insufficient because, for example, the contractor warranty may not provide the detailed warranty the tenant would prefer. In addition, the contractor may never perform another job for the tenant. Thus, the tenant’s leverage with that contractor may be minimal. Finally, the tenant may encounter difficulty enforcing the warranty as a third-party beneficiary.
Landlord forms frequently start with a “non-warranty” position—specifically, that when the tenant occupies the property, it is deemed to have agreed that the landlord has satisfactorily performed all of the landlord’s build-out obligations. Tenants should try to strike this language. For landlords, such clauses can cut short the tenant complaints about work.

The landlord also may push to limit the tenant’s remedies in the event of a breach of the construction warranty to the repair of defects. If the defect is such that it materially impairs the tenant’s operations, the mere fixing of the defect may not make the tenant whole.

Another subject of warranty negotiations is the duration of the warranty. Landlords frequently offer tenants a one-year warranty, starting at the date of substantial completion of the work. From a tenant’s standpoint, a longer warranty period is preferable, though it comes at a cost. If the tenant desires a warranty period of longer than one year, or wishes that the warranty begin at the date of final (not substantial) completion, the tenant’s specifications should so state.

Another point of contention in warranty negotiations is one stating that the premises, when completed, shall comply with all applicable laws. A landlord may resist this warranty because the build-out follows approved construction plans and specifications. If the plans and specifications would result in a project that fails to comply with applicable laws, the landlord may argue it should not be held liable. This debate between the landlord and the tenant underscores the need for a continuing warranty in the architect’s contract that, if the project is built in compliance with the drawings, the project will comply with all applicable laws.

Allowance Issues

In addition to the amount of a tenant allowance, the parties may need to grapple with other allowance issues. For example, when the tenant needs to make a contribution to the cost of build-out work that the landlord is performing or has performed, the timing of the tenant’s payment warrants attention. Savvy landlords will require a tenant to contribute its amount to the build-out funds when the lease is signed or before the landlord incurs significant costs, rather than at a later time. The tenant may resist that request, particularly if the schedule calls for the work to be performed at a much later date. Often the timing turns on the tenant’s credit. A large credit tenant will have a much easier time convincing the landlord to accept payments as the construction progresses.

When the tenant performs (or has performed) the work and receives an allowance from the landlord, the timing of these payments is a significant issue for the tenant. The tenant will incur construction costs during the course of the project, and contractors and subcontractors will want to be paid. The landlord’s preference often will be to withhold any payments until substantial or final completion has been achieved to verify the work is performed well before the landlord’s funds flow. That puts the tenant in the position of fronting costs during construction and being reimbursed for those costs later.
Construction Loan and Payment Issues
When either the landlord or the tenant is procuring financing for the build-out, the terms of the construction documents need to be in sync with both the lease and the loan documents. For example, if the tenant is performing the build-out but the landlord is paying for some or all of that build-out using the proceeds from a construction loan, the landlord should verify that it is not required to disburse funds to the tenant before the construction lender itself has disbursed those funds. Similarly, the landlord’s construction contract with the contractor should, from the landlord’s perspective, condition its requirement to deliver payments to the contractor on the construction lender’s release of that payment. Contractors usually will balk at such a “pay when paid” structure.

Two issues related to payment are retainage and payment timing. Retainage is an amount that a construction lender or a party contracting to have work performed withholds from the contractor or subcontractor, usually until substantial completion or in some cases final completion. For example, the construction contract may provide that 10% of each progress payment during construction shall be withheld until substantial completion has been achieved. The party (whether the landlord or the tenant) contracting to have the construction work performed needs to confirm that the construction loan’s retainage requirements are consistent with those under the construction contract. Retainage is also a matter of local law and practice. Because a primary purpose of retainage is to avoid mechanic’s liens, the parties should review local mechanics’ and materialmen’s lien statutes to determine whether any particular requirements must be met to avoid such liens. For example, in Texas if an owner withholds 10% retainage through completion of the project, then any liens will attach only to the retainage and the owner’s liability will not exceed the 10% retained funds. Tex. Prop. Code § 53.101.

Lien waivers are another area in which the party contracting to have the work performed will want to make sure that the respective provisions of the construction loan documents, the construction contract, and the lease are consistent. The AIA A201—General Conditions of the Contract for Construction, for example, does not require lien waivers as a condition of the release of progress payments. Construction lenders typically require lien waivers as one of several preconditions for the release of progress payments. If the tenant is contracting to have the work performed and being reimbursed by the landlord for costs, landlords are advised to require lien waivers as a precondition to the release of progress—and final—payments. The tenant will then need to make sure its construction contract requires the contractor to deliver those lien releases.

Conclusion
As this discussion demonstrates, a build-to-suit lease is no ordinary lease. Practitioners negotiating build-to-suit leases should focus on specifying the work to be done during design and construction, specifying the party bearing that responsibility, and addressing ramifications (or lack of ramifications) for the non-occurrence of those requirements in accordance with their client’s interests.