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Commercial tenant improvements: Key considerations for lease negotiations - Laura Kaplan

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A significant inducement in many new leases and lease renewals is landlord funding and/or constructing improvements that customize the leased premises to the needs of the tenant's business. The allocation of cost for these improvements is a fundamental economic term of the lease/renewal that affects the base rent per square foot payable over the lease term – it is usually stated in the term sheet. This article focuses on the considerations related to tenant improvements that are worked out later, in the negotiation of the lease or renewal amendment for a traditional lease (i.e., a lease where the landlord owns and maintains the structural components of the building during the term of the lease).

Designing the Improvements: Unless design plans for the improvements are agreed in advance, the lease will indicate which party is responsible for developing the plans, typically giving the other party approval rights over the plans and, sometimes, over selection of the architect or engineer. Timelines for approval should be specified and, in some cases, provision can be made for (i) deemed approval if the approving party fails to timely respond or (ii) adjustment to the rent commencement date (moving it forward for tenant-caused delays and moving it back for landlord-caused delays). The lease should indicate which party is responsible for ensuring the design of the improvements complies with all applicable laws. Landlords also may wish to describe their requirements for design and materials to help ensure that the improvements are appropriate for the building/project.

Permitting the Improvements; Compliance with Laws: Typically, the party performing the work is responsible for obtaining permits (with the landlord having a duty to cooperate, at no cost or liability to landlord, with tenant's efforts to obtain any necessary permits). A landlord will often require that, except for work to be completed by the landlord (if any), the tenant accepts the leased premises in its "as is" condition. In general, this type of provision usually means the lease contains no landlord representations or warranties to the tenant regarding the condition of leased premises. Often, the lease also makes the tenant responsible for compliance with applicable laws. These provisions taken together could mean that tenant's work must include correction of existing defects as necessary to obtain governmental approvals for the planned improvements. Tenants often negotiate for representations that the leased premises comply with applicable laws and/or that the building systems serving the premises are in good working order and repair. At a minimum, a tenant will want to conduct thorough due diligence investigations to obtain a detailed understanding of the existing condition of the leased premises.

Completing Construction: If the tenant is constructing the improvements, the landlord will often provide a defined period for construction before rent commences, with rent commencing regardless of whether tenant's work is complete. Landlords sometimes require tenants to use a landlord-specified contractor and often require approval of the general contractor performing the improvements.

If the landlord is constructing the improvements, the tenant will want to ensure a clear definition of when those improvements are "substantially complete" sufficient to enable the tenant to accept delivery of the leased premises and either commence tenant's work (if any) or conduct tenant's

business at the leased premises. In general, the architect's determination of substantial completion is often treated as conclusive, but some tenants negotiate an opportunity to conduct their own inspection of construction and generate their own "punch list" of items that must be completed by the landlord within a reasonable time following delivery of possession. Some tenants also negotiate a warranty of landlord's work, which at a minimum requires the landlord to pass through to the tenant any warranties they receive from their contractors.

Many form leases do not specify a clear delivery date or do not provide tenants with any remedies for landlords' failure to timely complete construction and deliver the leased premises. Tenants can negotiate for a clear timeline and for remedies for landlord delays. For minor delays, a landlord might push back rent commencement and, sometimes, reimburse any holdover costs the tenant incurs at its current location. For major delays (subject to force majeure), tenants can obtain a right to terminate the lease (with or without cost reimbursement). Additionally, tenants can negotiate for access to the premises during landlord's work for purposes of taking measurements and installing cabling or conducting other tenant work, though landlords will require that such access not interfere with landlords' work and that tenants provide evidence of insurance coverages.

Paying for the Work: Tenant improvement allowances are often for a fixed sum, with the tenant forfeiting any amounts not used within a reasonable time. However, some tenants negotiate for unused sums to be applied to payment of future rent.

A key negotiation point is the timing of payment of the tenant improvement allowance. Many landlords require tenants to pay the tenant improvement costs and receive reimbursement only upon completion of the work and providing final lien waivers. Some leases have additional payment conditions, such as obtaining a certificate of occupancy (if applicable) and opening for business in the leased premises.

Some landlords fund "hard costs" such as labor, materials and building systems and either exclude or cap "soft costs" such as architectural and consulting fees. Inclusion of "soft costs" as well as costs related to furniture, fixtures and equipment not permanently affixed to the property are often negotiated. To retain greater control, some landlords pay contractors directly up to the agreed allowance amount rather than disbursing funds to the tenants. In addition, some landlords charge supervision/management fees in connection with tenant improvements, which have the effect of reducing the tenant improvement allowance funds available for other costs.

For larger or longer-duration projects, tenants may negotiate for periodic disbursements of the tenant allowance upon presentation of partial lien waivers. Landlords considering such an arrangement may wish to require retainage (i.e., withholding a percentage of the tenant allowance until final completion) and/or requiring that tenants either expend their own funds before drawing on the allowance or fund them *pari passu* with the landlord (i.e. tenant expends its own funds in an agreed proportion with the landlord during the course of construction, with tenant responsible for any costs in excess of the approved budget). Tenants in these arrangements will want to specify the

timeline for landlords to respond to requisitions as well as any special remedies. Some tenants might be able to secure a right to a rent offset for landlord's failure to timely pay the tenant improvement allowance, though many landlords strongly resist granting any rent offset rights.

Surrender: While tenants are usually allowed to leave in place structural improvements made during the lease term, some landlords will require tenants to remove those improvements and return the leased premises to their original condition at the expiration or termination of the lease. In all cases, the lease should specify clearly which tenant improvements are to remain and which are to be removed. Landlords may also wish to consider the costs of any required restoration when setting security deposit amounts.

Conclusion: This article provides a high-level overview of commonly negotiated points related to tenant improvements. The resolution of these items often depends on many factors, including among others: the creditworthiness of the tenant, the duration of the lease term, the scope of construction, and which party is performing the work. When navigating these issues, it is important to work with experienced legal counsel as needed to protect your interests.

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