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Perspectives - Susanna Fodor of Scarola Malone Zubatov

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In a recent visit with The Rooftops Project’s Alicia Langone and Professor James Hagy, construction lawyer Susanna Fodor offers views on the tenant improvement process when a not-for-profit organization selects space to lease and on routine repair and renovation projects for properties a not-for-profit may own.

Susanna Fodor is a partner with the New York law firm Scarola Malone & Zubatov. She is among only a few attorneys in the United States with the distinction of being elected to membership in both the American College of Real Estate Lawyers and the American College of Construction Lawyers. Her dual skill set, coupled with a pragmatic business sense, has made her counsel of choice to a diverse and dynamic client base undertaking transactions in the real estate and construction spaces throughout the world. She also has a long-standing dispute resolution practice, and serves on the American Arbitration Association’s Large Complex Construction Case Panel.

RTP: In addition to working with clients on the construction of buildings and infrastructure projects around the world, you also have helped innumerable tenants taking spaces, large and small, where construction or renovation work was to be done in the space before the tenant moved in, so-called “tenant improvements”. What professional support team may a not-for-profit tenant need where tenant improvements are involved?

Susanna: From the start, my question is, “how big is the project”? That question is really the same whether the tenant is a “not-for-profit” or a “for-profit” entity. The nature of the professional support team needed would depend on the size and scope of the tenant improvements. If the tenant improvements consisted primarily of interior decorating work, such as painting, cabinetry, and floor covering, for example, a tenant would not need either an architect or a general contractor. What the tenant would need would be the “trades”, subcontractors or vendors that perform painting, cabinetry and floor covering work. It would be similar to what you would do to renovate your own apartment or home.

For tenant improvements of a larger size or scope, a tenant would be well advised to retain an architect or a professional consultant (such as a project management firm) to guide it through the design and construction process. The requisite assistance to be provided beyond design would consist of, and would generally include, the identification and selection of a general contractor; providing guidance on whether the construction would be best suited to be awarded on a negotiated contract (“cost plus” or “guaranteed maximum price”) basis, or awarded on a “fixed price/lump sum” basis; and whether competitive bidding should be a part of the process at both the general contractor and subcontractor levels or only at the subcontractor levels. The architect or consultant the tenant chooses to work with would likely have relationships with numerous contractors for tenant's consideration. The tenant’s professional team could then oversee the tenant improvement process from its inception to its completion.

Everyone that works in this field (be it a broker, architect, consultant, attorney or contractor) is looking to build a long term relationship with the tenant, not only for future repeat business, but also for positive referrals by the tenant to others. The whole business is based on repetition, being able to network. I think this is important to be cognizant of. A lot of people may look at these kinds of “relationship building” as something that should be frowned upon. My view, however, is that a better job is likely to result from having an opportunity to develop additional business through referrals from happy customers.

RTP: The design process focuses primarily on how the space will be built to the client's specifications. But another element of a thorough evaluation is the condition, the characteristics, of what is known as the “base building”, the floors and walls, the building systems. Why does this matter to a tenant?
Susanna: If it is a new building, the tenant usually gets a work letter from the landlord that specifies where the landlord’s work stops, and where the tenant’s work starts. That work letter needs to be negotiated and included as part of the lease. Since the demarcation is far from precise, and it is largely technical, most tenants without in-house design and construction expertise are ill equipped to negotiate the work letter themselves. As such, my view is that all work letters, and especially those for larger size and scope tenant improvements, should be negotiated on behalf of the tenant by a knowledgeable entity representing the tenant. As I mentioned, could be an architect, a consultant, or another construction professional.

For larger projects, I would prefer to have a contractor also look at the work letter, because it is nuts and bolts. You are going to get “x” linear feet of stuff, and the pipes are going to interplay with one another. Maybe the contractor can realize cost savings if the pipes interact another way, different from the initial design proposal. The contractor really is the one who has the technical know-how.

RTP: Are the cost savings for the benefit of the tenant or the landlord? Does it matter to your example whether it is the landlord or the tenant who is responsible for the tenant improvement work and who pays for it?

Susanna: Whether it is the landlord or the tenant that is responsible to bear the cost of the tenant improvements, the tenant always ends up paying for it in one form or another. In the lease, either the landlord will provide a “tenant allowance” and allow the tenant to build out its own space, or the landlord will agree to build out the space for the tenant. Under both scenarios the landlord would factor the construction costs into the rent, or charge the tenant for building out the space as the costs are being incurred. That’s true even in a so-called “turnkey” transaction where the landlord is giving the tenant a finished space. As the saying goes, “there is no free lunch”. The only issue here is to be vigilant in guarding against the landlord looking at this process as a “profit center.”

RTP: Is there an advantage of using a landlord’s contractor because that contractor also knows the building well?

Susanna: Yes. The building contractor’s and the building’s engineers’ familiarity with the building could be of benefit. As such, whether the landlord builds out the space or the tenant builds out the space, if it is important for the tenant to be mindful of the fact that someone who knows the building may be a better choice than someone who lacks such knowledge. But in today’s computerized world, the learning curve is always on the rise and such knowledge can be acquired very fast.

RTP: So, if it’s an in-house construction team that I guess some landlords have, or if it’s a preferred contractor that the landlord uses all the time, how is the pricing transparent for the tenant? You can’t bid or compare prices because you are using someone that’s handed to you?

Susanna: That’s an interesting question. Lawyers who work on these types of projects on a routine basis know the market and they know how to navigate this important and challenging economic issue.

RTP: The lawyers aren’t able to review or estimate the cost of the labor and materials for the job, though?

Susanna: No, that’s right. But a tenant can get protection through competitively pricing the labor and material costs at the subcontractor and supplier levels. Lawyers in this field know what should be charged as a markup by the contractor beyond the labor and materials being sourced out on a competitive basis to subcontractors/suppliers. Those markups generally consist of the contractor’s fee, general condition costs, insurance premium and bond costs, contingency, and a myriad of other cost components, all marking up the price. I don’t want to give the impression that one cannot accomplish the project at a fair price. You can. But, there is a lot of detail, the nitty gritty, that we cannot get into here. How many competitive bids from the various subcontractors should one solicit? Should the tenant or the landlord bid out the work through an RFP [a request for proposals] or another process to more than one general contractor? Should the general contractor be permitted to “self-perform” work? The tenant wants to use a lawyer, and an advisory team, with real knowledge of how these things work.

RTP: Often the proposal from a landlord may include a so-called “tenant allowance,” essentially a maximum budget the landlord will provide toward the construction of the tenant improvements in the space. How is the use of that money determined and controlled?

Susanna: The size of the “tenant allowance” and its availability is market driven. Tenants with bargaining position will negotiate up front how the allowance can be used. Generally speaking, it can only be used for things that better the space, because the tenant is going to be asked to leave the improvements at the end of the lease. They become the landlord’s property. If you don’t have any bargaining position, then the allowance often cannot be used for furniture that you may want to take with you at the end.

Terms relating to the tenant allowance most often negotiated are whether the allowance may be used for anything other than “hard costs”, and whether the allowance can be used for “soft costs” as well, such as architectural and engineering design fees, legal fees, consulting fees, and the like.

RTP: At this stage of the process, the design stage, what if what you want designed and included in the tenant improvements is too expensive, that is, more than the tenant allowance from the landlord?

Susanna: Unless the landlord agrees to increase the allowance, this is a problem for the tenant to solve. You may either have to put up the money for the difference or figure out how to reduce scope. Reducing the scope means to cut back on what’s been designed, or to reconfigure the space to realize cost savings. The project may be delayed by this process, and if the tenant has a schedule to meet, needing to move in and needing also to move out from the space it is occupying now, this can be time sensitive.

RTP: Once you have a set of plans that fit your budget, how can you guard against those costs exceeding the tenant’s budget?

Susanna: A complete answer would require a whole law school course in construction, or telling you all the lessons from my long career! [laughter]
In general, there are three models to cost a construction project. The one favored by many contractors is a “cost-plus-a-fee” arrangement. Cost-plus-a-fee means that the tenant is responsible to pay the agreed, itemized costs enumerated in the contract. In this scenario, the contractor also gets a percentage of the allowed costs as its fee, which percentage varies from market to market. The contractor also gets a percentage for so-called “general conditions,” which are out-of-pocket costs of the general contractor for certain items such as insurance, supervisory labor, and other general costs, all of which are above and beyond costs the contractor pays to subcontractors and suppliers for labor and materials. There can often be disagreement over what is reimbursable and what is not. This disagreement is resolved by negotiation as part of the process of reaching the final version of the contract that will be signed.

**RTP:** What are the other basic models for construction contract pricing, other than “cost-plus”?

**Susanna:** The next model is a “lump sum” contract arrangement, which is generally competitively bid at the general contractor level. Under this scenario the tenant agrees to pay the contractor a set price for what is specified in the plans and specifications. Lump sum contracts should not be used unless the plans and specifications depicting the work to be performed are complete and sufficiently detailed so as to facilitate “apples to apples,” competitive solicitation of bids that are clear and do not leave room for interpretation.

**RTP:** So you have mentioned “cost-plus” and you have mentioned “lump sum”. What is the guaranteed maximum price, or “GMAX”, construction price model?

**Susanna:** Most of the projects that I have worked on (the very large ones) have used the GMAX costing model. Typically, the clients who adopt GMAX contract models are sophisticated about construction matters, as are the contractors. Everybody knows what they are getting into. The contractor takes the risk of the project costing more. You have to pay the contractor for taking that risk, so his bid is going to be higher than with a cost-plus model. And with a guaranteed maximum price contractor again, from an economic standpoint, anything not in the plans and specifications will be extras for which the contractor can charge more.

In a GMAX price model, one should strive for an open book process at the subcontractor bid level. The laundry list of reimbursable costs should be carefully defined and scrutinized. The use of “contingency” should be proscribed. Shared “savings” should be addressed. It is a challenging model to manage and the tenant would need to have its architect or consultant checking every expenditure.

**RTP:** If an organization doesn’t have experience with construction contracts and these pricing models, then it might not know whether the price or bids it is receiving are reasonable for the scope of work and for current market conditions. Is this where the architect, a project manager, or other professional consultant can be important in leading the organization through that process?

**Fodor:** Yes.

**RTP:** When the landlord offers a tenant improvement allowance, where does that money come from?

**Susanna:** Often the landlord will be getting the funds from its lender. The repayment most often comes through the rent paid by the tenant over the term of the lease.

**RTP:** But the tenant seldom meets or deals with that lender in the lease negotiations?

**Susanna:** Correct. Sophisticated tenants with bargaining leverage may also negotiate whether the lender providing financing is required to assume the landlord’s payment obligations if the landlord defaults in completing or paying for the tenant improvements.

**RTP:** What factors can affect the price, and cost the tenant more, even after construction has started?

**Susanna:** The plans and specifications may be incorrect or insufficient. Or the tenant may change its mind regarding scope or details and quality of construction. Then there can be “differing site conditions,” a clause in the construction contract that addresses, in a tenant space, what is “behind the walls.” In my mind, contractors are entitled to a change order (providing additional time and money to the contractor) if things behind the walls turn out to be different from what was anticipated in the plans or what could have been discovered from permitted probings.

**RTP:** That affects scope but also might affect time delays and associated costs?

**Susanna:** Yes. The contractor should not be expected to absorb associated delays. When scope is changed, the contractor should be entitled to both additional costs and additional time.

**RTP:** These types of delays are different than what the industry knows as force majeure, an event like unusual weather conditions or storm damage that cannot be controlled by the parties?

**Susanna:** Yes. Those force majeure provisions are also subject to negotiation. Those negotiations usually end up, or should end up, with a commercially reasonable allocation of risk between the parties.

**RTP:** Construction contracts can be lengthy and, especially if there are a lot of negotiated changes, very complicated. On the typical project, how are all of those provisions used and administered in the field as construction progresses?

**Susanna:** In my experience, the value of having a well-written contract is to clearly set forth the expectations of the parties going forward. The time spent in the course of negotiations should be welcomed by both parties, since it serves as a platform for them to understand what is expected of each other. That is why many large companies bring the team – project managers, superintendents – and they are all sitting in the room to hear and understand what it is that is being agreed. These same people will be administering the project.

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RTP: If the owner doesn’t do a lot of this kind of work, it helps them understand what to expect, too?

Susanna: Yes.

RTP: Even where the tenant may pay directly in advance for the tenant improvement construction costs, when the lease term is over and the landlord regains control of the space, it is typical that those improvements become the property of the landlord. Is that fair? Can it be negotiated?

Susanna: Usually leases provide that whatever the tenant puts into the building belongs to the landlord. The tenant can only remove its movable property (furniture and business equipment, for example). Many times this is what tenants would want to do anyways—leave the tenant improvements there and move out. That is primarily because the improvements may not be configured to fit into the next space the tenant may be relocating to.

RTP: Many real estate lawyers are familiar with negotiating leases and may even deal with tenant improvement work letters regularly. Then there are construction lawyers, but many of them seem to focus on litigation over construction disputes. You have spent much of your career focus specifically on construction in the context of transactions, rather than disputes. Is this unusual in your business?

Susanna: Construction lawyers do vary in what they do for a living. Some do nothing but construction or nothing but design. Most usually represent the trades [contractors or subcontractors like plumbers or electricians.] They are primarily litigators representing the interest of the contractors, the subcontractors, and the architects. I happen generally to represent owners. My practice is primarily transactional: leasing, design, development, and construction. I ended up making a niche for myself in the real estate world. I am one of only three lawyers in the U.S. who are both a member of the American College of Real Estate Lawyers and a fellow of the American College of Construction Lawyers.

RTP: Those are both invitation-only, honorary organizations for accomplished senior lawyers in their fields.

Susanna: Yes. The fellows in the American College of Construction Lawyers are primarily litigators. I think that, as time goes by, more real estate lawyers are looking at transactional construction and design law as something they had better learn. When you represent a client in negotiating a lease like this, you need to know the realm of design and construction law and you have to know the market.

RTP: We have talked a lot about tenant improvement projects for leased space. Let’s explore your perspective for a moment on routine repair or renovation projects, which a not-for-profit organization might undertake at a property it owns or that it leases. While it would be worthwhile to have the benefit of paid or pro bono legal review, some organizations might be asked just to sign the contractor’s form or even a purchase order. How complex, or simple, should the construction documents be this for type of project? What if a vendor wants to do the work with no contract?

Susanna: So, do you need a contract at all for a small project? I would answer “yes”, regardless of how small. I think that’s prudent business practice. One of the things I am going to do if I am reincarnated is to figure out how to simplify not only construction contracts, but design agreements, leases, purchase and sale agreements, all of these.

At one time in my career I was asked by a client to prepare a wine cellar construction contract. The wine cellar was probably 6,000 square feet. I said to myself, “this is my opportunity to do something other than using an industry or other form, or crossing out a lot of terms in contracts we have used many times”. I came up with a wine cellar contract that was two pages long. I thought, “I should take this on the road and sell it”. [laughter]

I still have that contract. It has five elements: a start date, a completion date, a description of the scope of the work, an insurance provision, and a warranty provision that said there will be no defects in the work. I didn’t go on and define what defective work was. There is an industry term as to what “defective work” is. I think that state common law, at least in New York, would protect someone who is wronged because they got a defective product or, in this case, a defective renovation of your space.

RTP: Those five elements also seem like a checklist if a small contractor does come with just a clipboard of purchase orders. Frequently that sheet of paper may have no start and end date at all, for example.

Susanna: Small organizations, including not-for-profits, are often faced with vendor purchase orders. They are lengthy and they are worse than a construction contract. They can have all kinds of inapplicable “boilerplate” and other things in them. But often one can’t negotiate it.

RTP: Here is a final test, Susanna. You own a house. The last time you needed a repair, or a new roof, or a new furnace, and the vendor handed you a purchase order, what did you do? Did you sign it? Did you negotiate it? Did you give him your form instead?

Susanna: No. I did not enter into a purchase order/contract at all. We described scope in an email that stated that he was going to install a central air-conditioning unit for my home, setting forth the price and the contract time. But, first of all, he was highly recommended by other people for whom he did work similar to mine. Second, he needed my follow up recommendation to create more work for himself. So all was “fine,” and I felt protected. And (I can see you laughing already), many times when people find out I’m on the other side of a transaction, they behave differently, too.

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