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IN THE SPOTLIGHT

LEASE EXTENSION OPTIONS - A LANDLORD'S PERSPECTIVE

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Most landlords prefer to avoid granting options to extend the term of a lease but, as a valuable inducement that landlords can offer to prospective tenants, will frequently agree to grant them. This article will explore, from the landlord's perspective, how to evaluate and craft an option to extend. A moderate, landlord-oriented sample option to extend the lease term provision is also included for your convenience.

Use Option to Extend (Avoid Option to Renew)

There are differences between an "extension" option and a "renewal" option. An option to renew creates a new leasehold estate and effectively surrenders the original lease. Landlords might inadvertently expose themselves to an argument by a tenant that renewing the lease should repeat all of landlord's lease concessions (which are commonly front-end loaded). Stick with "extension" language, which will continue the existing leasehold estate (and stay away from "renewal" language).

Questions to Ask

Before drafting an option to extend provision for a lease (or letter of intent), the parties should be able to answer the following questions:

1. *How many extension periods will tenant have and how long will each extension period last?* Landlords generally prefer to limit both.

2. *By when will tenant have to notify landlord that tenant is exercising an option?*

Landlords should provide themselves sufficient time to market the space to new tenants if the existing tenant does not exercise an extension option. Landlords will also prefer to prevent notice from being delivered by tenant to landlord too early in the term because they will want as much default-free performance by the tenant as practically possible and options to extend commonly set the new rent for the option period based on the "market" then existing (and establishing the "market" as close to the extension period commencement date is sensible).

3. *How will tenant's notice be provided?* The notice must be in writing. The lease notice section routinely addresses how notices are delivered.

4. *What terms of the original lease should be excluded during the option to extend?*

Landlords should avoid repeating rent abatements or other concessions (including initial construction build-out requirements) if tenant exercises an option to extend.

5. *What is the rent amount and/or how will the parties determine the rent amount?*

Assuming the rent amount has not been fixed at the time the existing lease was entered (and will be set at “market”), the parties should try to anticipate how much time may be needed to determine the same. Stay away from using language such as “to be agreed upon” in order to prevent claims that the option is deemed to be void for vagueness. Landlords and tenants occasionally determine extension term rent by linking it to changes in a consumer price index. However, most consumer price indices frequently have low correlation to commercial real estate market rents and, accordingly, CPI methodology is not widely embraced in this context. Landlords and tenants more commonly establish extension term rent amounts through direct negotiations among themselves and, if they are unable to agree upon the new rent after a good faith attempt for a reasonable period, they can resort to an appraisal or arbitration process. The lease should provide sufficient information to direct the parties through the appraisal or arbitration process.

- a. *What is the relevant “market” for purposes of determining “market rent”?* Enumerating the geographic area and type of property with a reasonable amount of particularity would be helpful.
- b. *What qualifications must the appraiser and/or arbitrator meet?* The appraiser and/or arbitrator should be highly qualified and experienced in both the geographic area and type of property being leased.
- c. *How much time will the appraisers need to perform their work?* It would be unusual for an appraiser to need more than thirty days.
- d. *Should there be a rental “floor”?* Landlords commonly seek protection against rental declines so that rent during the extension term will not be less than the rent during the last year of the previous term.
- e. *Should tenant be able to rescind the extension option after market rent is determined?* Most landlords will resist a tenant rescission right (and tenants rarely insist on one).
- f. *If arbitrated, what form or rules control?* “Baseball arbitration” is a common form of arbitration used to determine market rental rates.
- g. *How are percentage rents addressed?* In a retail lease context that includes percentage rent payments, make sure to adjust the breakpoint to match the new base rent.

6. *What conditions should landlord impose on tenant’s right to exercise an option to extend the lease term?* First, a tenant should not have a right to exercise an extension option if the tenant is in default under the lease (at the time of exercise and at the extension term commencement date). Some landlords may be willing to allow an exercise of an extension option as long as the tenant is not in “material” default.

Second, landlords should consider restricting extensions by a tenant whose financial condition has deteriorated since the outset of the lease or is otherwise financially unstable. A landlord may want to require a tenant to regularly provide updated financial information and, if the tenant’s net worth has dropped below a designated threshold, landlords should preserve a right to cancel or otherwise void the extension.

Also, in certain retail leases in which the tenant is a franchisee, landlords should secure evidence from the franchisor that the franchisee is still in good standing with them. If the tenant is a chain, landlords can consider whether to prohibit the extension if the tenant no longer has some requisite number of stores.

Further, most landlords will want the extension option to be exercisable only by the original tenant. If the premises has been subleased or if the lease has been assigned, the personal extension option should not be exercisable. In a retail leasing context, some landlords might agree to permit assignees to exercise the extension option if the assignee's gross sales exceed the original tenant's gross sales for a reasonable time period.

Additionally, if the tenant has vacated some or all of the space, most landlords will want to prohibit the tenant from having a right to exercise an option to extend the lease term. Imposing continuous operation covenants on retail tenants is beneficial to landlords. If a tenant is responsible for paying percentage rent, a landlord should consider a requirement that the tenant reach a minimum sales threshold as a condition to exercise of an option to extend the lease term.

In addition, any third party lease guarantees should be expressly reaffirmed as a condition to the effectiveness of an option to extend the term of a lease.

Landlords should also consider modifying the amount of the security deposit to correspond to the new rent. If the tenant has operated without a default under the lease, a landlord should anticipate the tenant will resist an increase to the amount of the security deposit (and may push for a reduction).

Finally, upon mutual understanding of the new terms, landlord and tenant should execute a comprehensive lease amendment.

7. *How will an option to extend effect other lease provisions and related agreements?* An option to extend the term of a lease should not be evaluated in a vacuum. Do not overlook the notice, assignment/sublet, successors and assigns, alterations, security deposit and percentage rent clauses in the lease. Similarly, agreements relating to the lease (such as subordination, non-disturbance and attornment agreements, memoranda of lease, guaranties, workletters, and agreements with tenant's lenders) should be considered in connection with lease extension options.

Conclusion

Once a landlord agrees to grant an option to extend the term of a lease, before drafting a lease or letter of intent, a landlord can use this article to help identify and evaluate the issues that may emerge and should be considered. Armed with the ideas described above, landlords should be in a better position to address the parties' respective rights and obligations and achieve mutually agreeable and practical solutions.

Sample Option To Extend Provision (Landlord-Oriented/Moderate)

OPTION TO EXTEND. Tenant shall, provided the Lease is in full force and effect and Tenant is not in default under any of the terms and conditions of the Lease at the time of notification or commencement, have one (1) option to extend this Lease for a term of ____ (__) years as of the date the extension term is to commence, on the same terms and conditions set forth in the Lease, except as modified by the terms, covenants and conditions as set forth below:

a) If Tenant elects to exercise said option, then Tenant shall provide Landlord with written notice no earlier than the date which is _____ (__) months prior to the expiration of the term of the Lease but no later than the date which is _____ (__) months prior to the expiration of the term of the Lease. If Tenant fails to provide such notice, Tenant shall have no further or additional right to extend or renew the term of the Lease.

b) The Annual Rent in effect at the expiration of the term of the Lease shall be adjusted to reflect the current fair market rental for comparable space in the Building and in other similar buildings in the same rental market in _____ as of the date the extension term is to commence, taking into account the specific provisions of the Lease which will remain constant. Landlord shall advise Tenant of the new Annual Rent for the Premises no later than thirty (30) days after receipt of Tenant's written request therefore. Said request shall be made no earlier than thirty (30) days prior to the first date on which Tenant may exercise its option under this Section __. Said notification of the new Annual Rent may include a provision for its adjustment to provide for a change in fair market rental between the time of notification and the commencement of the extension term, together with periodic increases during the extension of the term of the Lease. Promptly following Landlord's receipt of an extension option notice, Landlord and Tenant shall commence negotiations concerning the fair market rental that shall be payable during each year of the extension term. The parties shall have thirty (30) days after Landlord's receipt of the extension option notice in which to agree on the fair market rental that shall be payable during each year of the extension term. The parties shall be obligated to conduct such negotiations in good faith. If the parties agree on the fair market rental payable during each year of the extension term, they shall promptly execute an amendment to the Lease stating the rent so agreed on. If Tenant and Landlord are unable to agree on a mutually acceptable rental rate not later than _____ (__) months prior to the expiration of the term, then Landlord and Tenant shall each appoint a qualified MAI appraiser doing business in the area with not less than _____ years of experience, in turn those two independent MAI appraisers shall appoint a third MAI appraiser and the majority shall decide upon the fair market rental for the Premises as of the expiration of the term. Landlord and Tenant shall equally share in the expense of this appraisal. In no event shall the Annual Rent and Monthly Installment for any option period be less than the highest level of Annual Rent and Monthly Installment in the preceding period.

c) This option is not transferable; the parties hereto acknowledge and agree that they intend that the aforesaid option to extend this Lease shall be "personal" to Tenant as set forth above and that in no event will any assignee or sublessee have any rights to exercise the aforesaid option to extend.

Tenant shall have no further right to extend the term of the Lease.

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