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Commercial Leasing: When is an Option to Extend Truly an Option?

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A properly drafted option to extend the term of a lease is a significant benefit for a commercial tenant. Assured of the option for a lengthy lease term, the tenant can focus on growing its business rather than worrying about relocation logistics and costs. Meanwhile, the tenant can maintain the flexibility to leave a leased property at the end of the original lease term if the location proves unfavorable.

Landlords historically resisted extension of such options, due to their desire to maintain flexibility in regard to the use and marketing of their properties and to preserve negotiation leverage against tenants desiring to extend their lease term. However, with more attention to the drafting of the option language, landlords have found ways to mitigate some of those concerns. In the present tenant-favorable market, landlords typically grant such a significant concession to encourage good tenants to renew their leases, to avoid paying brokerage fees for marketing the premise to new tenants, to minimize the cost and inconvenience of new tenant improvements, and to minimize the risks of significant vacancies.

The basic concept regarding an option to extend is straightforward, but the significant economic impact of the provision on landlords and tenants makes the provision well worth extra attention. Unfortunately, all too often, practitioners overlook the importance of drafting the proper language for this critical provision. For example, I recently came across an industrial lease which contained the following provision:

Landlord hereby grants to Tenant, the right, at Tenant's option, to extend the term of this Lease at the expiration of the Lease Term for an additional term of five (5) years upon all the terms and conditions contained in the Lease, except that the rental payments shall be as mutually agreed upon by Landlord and Tenant. This option, if exercised by Tenant, shall be exercised by written notice given to Landlord on or before March 31, 2007.

This provision purports to be an “option” to extend the lease term, but will it allow the Tenant to sleep at night? Unfortunately not, as that is the only language in the entire lease regarding the option. This sample option provision does not establish a set rental rate during the option term, nor does it contain a means of determining the amount of the rent during the extension term. Therefore, if the Tenant exercises the option, the Landlord would be free charge any amount of rent it desired and could price the Tenant out of the leased property. I recently heard of a landlord, who had a similar option provision in the lease and increased a tenant’s rent by 300%, from \$5,000 per month (which was roughly the fair market rental value of the industrial property) to \$15,000 per month during the extension term, in hopes of encouraging the unwanted tenant to move out. A rental increase of 300% would be a disaster for most businesses, but, in this case, the tenant agreed to the increase because of the profitability of the location.

Most option provisions contain language stating that the option term rent will be based on the then-current “fair market rent,” but no less than the rent the tenant is paying at the time of exercising the option. Savvy tenants may even request that the option term rent be based on the then-current fair market rent, or the established rent at the end of the original lease term, minus a certain percentage (i.e., 2-3%) due to the cost savings the landlord enjoys for keeping the existing tenant (no vacancy period, little or no commission to the brokers, no tenant concessions or improvement allowances). Other possibilities for determining the amount of option term rent include increasing the tenant’s current rent by a set percentage (i.e., a 2-3% increase per year) or basing an increase of the rent on the local Consumer Price Index (CPI).

If the option rental rate is dependent on a determination of the fair market rent, it should be based on: (i) rents charged for similar leases with similar terms (not subleases, expansion space or other tenant’s lease extensions); (ii) premises which are comparable in location, size and quality to the subject premises; and, (iii) rents within comparable buildings (if any) in the vicinity of the subject property. The option provision should also have a dispute resolution provision such that a third party could determine the option rent if the parties cannot agree upon it. The third party could be a real estate broker with experience in the local market or a panel of brokers, if the parties cannot agree on a single broker. More extensive “baseball arbitration” provisions are common in very large leases.

Even with a stated mechanism for determining a fair market rental rate, in areas with high vacancy rates it is also common for tenants to offset proposed rental increases by requesting that that landlords provide extra tenant improvements or several months free rent during the extension term, in the same way a new tenant is provided with similar benefits. Such benefits can be drafted into the original extension option provision or become the subject of negotiation prior to the exercise of the option.

Landlords also seek to limit options to tenants in good standing; while savvy tenants seek to expansively define what constitutes good standing. Therefore, lease provisions should contain a restriction stating that no option will be available if there are any uncured tenant defaults or if there were more than a certain number of defaults during a time period prior to tenant exercising the option (e.g., more than two cured defaults during the original lease term). Such a provision

should have straightforward procedures for the exercise of the option and acceptance of the proposed option rent (if not predetermined by the present lease).

Tenants typically desire the flexibility to exercise their option near the end of their present lease term in case the tenant's business needs to relocate to a larger or smaller space or a different location instead of renewing. Landlords usually seek assurances that the tenant is committed to an extended lease term, at least several months prior to the expiration of the current term, to avoid a vacancy while the landlord tries to market the premises to other tenants. Nonetheless, properly negotiated option provisions should establish at least three set time periods during which: (i) the tenant must provide the landlord with written notice of its intent to exercise the option; (ii) the landlord responds with a quote for extension term; and, (iii) the tenant accepts or rejects the proposed option term rent.

Upon the proper exercise of the option to extend, the terms should be memorialized in a separate lease addendum and executed by the parties. However, in a situation where the initial lease term was lengthy and the original lease became outdated, the parties should consider updating the lease document instead of drafting a separate addendum. In that situation, however, exercise of the option provision could trigger negotiations over a multitude of other important provisions in the lease.

Although this article provides a number of drafting considerations specific to the option provision itself, the most important consideration is how the option provision works in the context of the overall lease. It is important to remember that no provision is negotiated, agreed upon, or ultimately operated in a vacuum. As such, the option to extend may have significant effects on the negotiation and operation of other provisions, such as subleasing/assignment or early termination provisions. However, with careful negotiation and proper drafting of the option provision, both tenant and landlord will sleep better at night knowing that the option to extend is truly an option.

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