Are Lease Renewal Options a Good Idea?

by Lloyd D. Hanford, Jr., CRE

Lease negotiations, more often than not, lead to a request from the lessee for renewal options. And, just as often, such options are freely given, without much thought or negotiation, by even the most sophisticated owners and managers. Yet, lease renewal options (LROs), like other kinds of options, raise some very fundamental questions. This manuscript examines the question of LROs, from the standpoint of the lessor, with a goal of being able to decide whether or not they are a good idea.

THE POSITION OF THE LESSEE IS EASY TO UNDERSTAND

It is very easy to understand the position of a lessee asking for a renewal option. It is relatively safe to conclude that, for a lessee, a LRO is never a bad idea regardless of the terms of that option. There is no mandatory requirement that the lessee must exercise a renewal option in order to be able to renew a lease. In all cases, a LRO is a "free ride" for the lessee. If the market conditions were such that the option is beneficial to the lessee, then the option would probably be exercised if the lessee intended to remain in the space. On the other hand, if the lessee determines that the terms of the option are not beneficial, the lessee can always opt to renegotiate instead of exercising the option. Accordingly, the lessee has absolutely nothing to lose when granted a renewal option, particularly when, as is most often the case, that option is given free of any charge.

LEASE RENEWAL OPTIONS ARE BINDING ON THE LESSOR

LROs raise some serious questions from the viewpoint of a lessor. There are several different basic option formulas. Each has its own particular set of problems. However, the common problem, regardless of formula, is that the terms and conditions of the option provision are, most probably, absolutely and irrevocably binding on the lessor while being

ABOUT THE AUTHOR

Lloyd D. Hanford, Jr., CRE, *is a real estate consultant and appraiser in San Francisco, with a western region practice. Hanford graduated from the University of California at Berkeley. He is a past national president of the Institute of Real Estate Management and was 1998 Chair of The Appraisal Foundation. (E-mail: Lloyd_Hanford@GMACCM.com)*

binding on the lessee only if the lessee exercises. The possible exception to this would be the case where the option is no more than an agreement to agree without remedy in the event agreement can not be reached. In many jurisdictions options based on an agreement to agree are not enforceable. In short, the lessor is bound by the terms of the renewal option if the lessee wishes it so but, if not, the lessee can choose to renegotiate. This situation transfers some of the control, over the future of the property or space, to the lessee. The fact that the lessee can choose whether to exercise or renegotiate sets up a "playing field" that is not "level" since the lessor has no such right (i.e. the right to decide to let the lessee exercise an option or, instead, to require a new negotiation).

EACH TYPE OF RENEWAL OPTION HAS ITS OWN PROBLEMS

Renewal options at preagreed rents are a problem from the standpoint that market rents at the time of exercise may be substantially higher than the agreed option rent. In this case, the lessee has every inducement to exercise the renewal option. But, in the event that market rents are lower than the agreed rent, there is every reason to believe that the lessee will opt to renegotiate rather than exercising the renewal option. However, a perceived benefit of options at a specified dollar rent amount is that they do not lead to controversy or dispute at the time of exercise.

LROs based on the percentage increase in the CPI or some similar index have the same problem. There is no correlation, other than purely accidental, between the change in the CPI and the change in market rents. Market rent is driven by the forces of supply and demand for the particular type of space in question. During the period of 1986-1996 there is substantial evidence to suggest that rents for office space, in many markets across the country, declined in the face of oversupply while the rate of inflation continued upwards. Similarly, in the period from 1996 to the present, the surge of demand for many types of spaces, in many markets, has pushed rents up in double-digit steps while the CPI has been increasing at a very benign rate. Accordingly, it may be concluded that the probability of a CPI or other index tracking the real estate rental market is minuscule. CPI or index rent adjustments during a lease term are theoretically different from options at specific dollar amounts in that they are perceived to maintain a purchasing power parity of the rent dollar during the period between new negotiations. Like specific dollar options, CPI adjustments do not present any controversy since the determination of adjusted rent is accomplished based on a fixed formula where the inputs are factually established.

The failure of specified dollar options or index adjustments to parallel the actual rental market changes led owners and managers to generally favor some type of market rate renewal option over other types of options. In theory, this is an excellent idea. No owner or manager should expect to get more rent from an existing, renewing lessee, than would be available in the market place if the space were vacant and available for lease. If the lessee moved out, that is the rent that would probably result from the space offering.

THE IMPLEMENTATION OF MARKET RATE OPTIONS IS A MAJOR DIFFICULTY

The major difficulty with market rate renewal options lies in the implementation of the process and procedures for determining market rent. In a different age, before the major shift to institutional ownership, lessor and lessee were both "risking" their own money when they failed to reach agreement and were forced to initiate the remedy spelled out in the lease such as arbitration. In that environment moving to arbitration was viewed by both parties as a risk and reasonable efforts were usually made to forge an agreement. Today, one or both parties have no personal, vested interest in the outcome of arbitration. Either the lessor is a corporate or institutional owner whose manager/negotiator is not personally at risk or the lessee is a corporate lessee with the same characteristics. In these instances, the party negotiator is only at risk of criticism (or second-guessing) for agreeing to a transaction that persons to whom the negotiator reports might challenge. Stated differently, the negotiator's job may be the only real thing at risk as far as the negotiator is concerned. Thus, for one or both party negotiators there may be no personal, economic inducement to agree to any rent other than the rent originally proposed by them. This tends to be the case even where the opening rent number was developed by an independent, outside appraiser or consultant. It is even more forcefully the case when a written, independent appraisal has been procured before the parties begin their negotiations. In this situation, many people on both sides may have reviewed, and signed off, on the respective appraisals, thus creating an expectancy of achieving the rent number established in their appraisal. In the vernacular, the feet of the parties become "set in concrete." The most defensive position for a negotiator or staff person charged with negotiating a

renewal rent under an option exercise may be to force the issue to arbitration by refusing to reach agreement. Under this scenario, an ultimate award decision against that person's position can be explained as beyond their control in that "those" arbitrators (who obviously were in error) decided it. On the other hand, if the arbitration results in a number that is favorable, the negotiator can take full credit for the genius involved in having "engineered" the situation to arbitration.

In recent years, the process has become even more complex with the deep involvement of attorneys beginning with the initial exercise of a market rent renewal option. Attorneys, as advocates, should be expected to seek out any possible interpretation of the lease (or market) that might lead to a favorable outcome for the client, regardless of how plausible or realistic the interpretation might be. Thus, before a disputed rent matter moves forward to arbitration or some other form of dispute resolution, certain issues may have to be legally resolved and/or extensive research must be undertaken to rebut interpretations believed to be in error. In the end, the result of legal maneuvering may be a formal submission agreement containing all party stipulations for use in the arbitration. However, the legal cost of this process can be very substantial.

As indicated above, when market rate options are granted, the lessor should anticipate that the lessee would employ the most favorable interpretation of lease language and develop their rental proposal to fit that interpretation. The use of the words "market rental value" or "fair market rental" etc. will most probably not protect against self-interest interpretations. It is true that self-interest should be expected to motivate both parties. However, since the question being examined is the advisability of a lessor granting a lessee a renewal option at a market rent, the fact that a lessor would act in its own self-interest in negotiations or arbitration is not relevant to the question.

THE "GAME"

Self-interest aside, market rate renewal options have a strong tendency to set up a "game." Assuming that both parties are equally well informed, it is fair to assume that each is aware of what the market is doing. However, the lessor can not expect to achieve a rent higher than market and from the viewpoint of the lessee, market rent is the worst anticipated outcome. Under conditions of this type, the lessee has little to lose in "playing the game." After all, if the matter proceeds to arbitration, isn't there a chance that rent will be concluded at less than market? From the lessee's viewpoint, Isn't there a chance that if enough issues are introduced into the proceedings, by the lessee, the confusion created may obfuscate the facts and result in a more favorable determination for the lessee? The observation of numerous rental arbitrations, over the years, indicates that the "game" is most frequently started when the dollars involved are very significant.

In recent years, the process has become even more complex with the deep involvement of attorneys beginning with the initial exercise of a market rent renewal option. Attorneys, as advocates, should be expected to seek out any possible interpretation of the lease (or market) that might lead to a favorable outcome for the client, regardless of how plausible or realistic the interpretation might be.

OPTION LANGUAGE IS USUALLY THE REAL PROBLEM

The real problem for lessors usually lies in the option language which, more often than not, is lacking in specificity. On the other hand, there is a practical difficulty in developing option language that is specific enough to eliminate any controversy as to how market rent will be determined. In order to illustrate this point, it is useful to examine the issues that might arise when, as is frequently the case, the lease language states nothing more than, "The lessee is granted the option to renew this lease for a period of five years at the then market rent. If lessor and lessee can not agree as to market rent, the matter shall be determined by arbitration (appraisal)."

- How is the term "market rent" or "fair market rent" to be defined? In a case several years ago, the lessee took the position that the word "fair" meant fair for both landlord and tenant and that the economics of the specific tenant's business (i.e. affordability) did come into play.

- Is the reference to "market rent" or "fair market rent" restricted to the specific use? This is an important question in retail situations where the current business may not be the best type of business for the space. If the lease is restrictive as

to use, some jurisdictions have held that the interpretation of "market rent" is to be market rent for that use and not some other use. Thus, if a lessor intends to achieve market rent for the highest and best use of the property, the option language must be very specific.

- Is the reference to "market rent" or "fair market rent" restricted to market rent for renewals only or does it include new leases? There have been cases where the tenant argued that the comparables are restricted to renewal situations and should not include new lease transactions.

- Do references to "market rent" or "fair market rent" mean "net effective" rent to the lessor? There have been numerous situations where tenants have argued the notion that renewals do not expose the landlord to lease commissions or down time between leases. Thus, the market rent indicated by examination of comparables should be adjusted by deducting the lease commission and down time to parallel the net a landlord would receive.

- What is the impact of tenant improvement allowances? For example, if comparable leases include new lease transactions with, say, $25 per square foot in tenant improvements, is the $25 amortized over the renewal term and deducted from "market rent" in determining renewal rent? Or, on renewal, does the tenant receive a tenant improvement (TI) allowance of $25 per square foot? Tenants have argued that, were they a new tenant coming into the property, they would receive the full TI package at the market rent and, that as a renewing tenant, they should receive a credit against market rent in the amount saved by the landlord who does not have to provide these TIs on renewal. In this instance, what the tenant would be seeking is the "net effective" rent to the landlord which, by definition, is different from "market rent" or "fair market rent." This interpretation also overlooks the fact that the landlord, in most instances, provided the tenant improvements when the renewing tenant originally moved into the space being renewed. On the other hand, if lease renewal comparables (vs. new leases) had, as a renewal condition, the provision of paint and new carpets, adjustment for this factor would probably be appropriate in setting renewal rent.

- What size space unit is comparable? If the subject space is 20,000 square feet are space units of 1,000 up to 20,000 square feet reasonable comparables? Or, would units substantially larger than 20,000 square feet be reasonable comparables?

- What are the time limits within which the parties must reach agreement before referring the matter to the alternative dispute resolution method set forth in the lease?

- In cases of long-term ground leases involving development of a project, the issues become very complex. What market conditions might exist and what other conditions and valuation methodologies might be appropriate in 30, 50, 60, or 75 years hence when renewal options might be exercised? If option rent is to be based on the value of the land as if free and clear of improvements, what will happen if, at the time, there are no comparable sales? Or, what might happen if, at the time, the area has been completely built up (no more vacant land) for more than 10 years? Should rental value assume the highest and best use of the land or is the then use to be considered as highest and best use?

  - Where there is an absence of relevant land sales data is the use of a land residual technique appropriate?

- If the matter is referred to an alternative dispute resolution methodology, what format will apply? The following are some of the choices:

  - There are different structures that might apply in an appraisal process where there is no dialog between appraisers. For example: 1). If the appraisals of the two party appointed appraisers are within 10 percent, the average becomes the "market rent." If the difference is greater than 10 percent then the party appraisers select a third appraiser and the appraisal most distant from the middle number is discarded with the remaining two appraisals being averaged. 2). The party appraisal closest to the third appraisal is the market rent. This format is similar to "baseball" arbitration. The major difficulty with any "averaging" of results is that it most probably will produce the wrong answer, either on the high side or low side and the problem of "baseball" is that the selected rent is not necessarily the correct rent based on the market.

  - An appraisal process where the appraisers are directed to meet in order to determine

whether or not they can agree or reconcile their differences to within 10 percent in which event the average would prevail. If no agreement were reached the party appraisers would select a third appraiser with two out of three being decisive. Once the appraisers are directed to meet, the process becomes an arbitration process and may be subject to the arbitration statutes in some jurisdictions.

- Arbitration with mandatory mediation as a pre-condition.

- "Baseball" arbitration where lessor and lessee jointly select an arbitrator and present their respective rental positions to that arbitrator. The arbitrator selects whichever of the two positions that is closest to his or her opinion to be the awarded rent. In theory, "baseball" arbitration is supposed to force both parties to propose a very reasonable position and attempt to agree before arbitrating. However, in practice, the process is often more akin to a poker game than to determining market rent in that, after negotiating, each party knows the other's position. The number finally submitted to the arbitrator becomes a "poker" number.

- An arbitration process conducted under the rules and auspices of the American Arbitration Association (AAA) or a similar alternative dispute resolution organization.

- An arbitration process where each party appoints its arbitrator and the two party arbitrators appoint the third arbitrator. This process raises its own issues:
  - Do the arbitrators prepare formal appraisals before commencing the process?
  - Will other experts present the market rent positions?
  - Will the process call for an open hearing where the parties present evidence to the arbitrators?
  - If the arbitrators are also the appraisers, should they share all data (but not analysis) before meeting?
  - Are there any appropriate party stipulations?
  - What qualifications must an arbitrator (or appraiser in an appraisal process) posses?
  - Must the third arbitrator be someone without any business or social relationship with the parties?
  - What time constraints will operate?

For the multitude of smaller lease transactions, the legal costs of negotiating and drafting detailed, specific language and the cost of implementing a highly-structured process for resolving any dispute may be unacceptable to both landlord and tenant.

The above are some, but by no means all, of the issues that can come up under lease renewal options at market rent. Market rate renewal options may contain some guidelines for determining rent. But, what happens when a guideline is no longer applicable? Several years ago an arbitration involving an older lease was conducted under lease guidelines specifying that market rent was to be based on recent leases in ***comparable one-story buildings*** within a defined area. However, at the time of arbitration there were no more one-story buildings within the defined area.

MARKET RATE RENEWAL OPTIONS SHOULD BE DETAILED AND SPECIFIC

In order for a lessor to be assured that market rate renewal option provisions contain adequate protections against unintended interpretations, it becomes necessary for those provisions to be very detailed and specific. In effect, the lease provisions setting forth the option terms and remedies if the parties fail to agree (i.e. arbitration) would take on many of the characteristics of a detailed arbitration submission agreement. Where lease transactions are large and involve major rent dollars, such specificity may be practical and affordable. However, for the multitude of smaller lease transactions the legal costs of negotiating and drafting detailed, specific language and the cost of implementing a highly-structured process for resolving any dispute may be unacceptable to both landlord and tenant.

Absent specific lease language that has the character of a submission agreement or absent a formal submission agreement, party arbitrators (or an arbitration panel) may have to develop a submission agreement for approval by the parties, before commencing the process, in order to protect the integrity of any award. Such an agreement would spell out the matter or matters to be decided as well as detail the rules and procedures under which the arbitration will be conducted. This process, in and

of itself, may increase the cost of arbitration, as well as protracting the time for reaching a decision. Further, if the arbitrators (or parties) cannot agree on the language of the submission agreement, the matter may have to be resolved by a court before the arbitration itself can move forward.

AN ALTERNATIVE TO RENEWAL OPTIONS

Aside from attempting to gain an advantage, the main concern of the lessee, in seeking renewal options, is being able to provide for continuity of occupancy in the leased space. One means of providing a lessee comfort relative to the future is to include a "First Right to Negotiate." This type of provision assures that the lessor will not lease the space to someone else before negotiating with the present lessee. This type of "right" does not bind the lessor to any rent but probably does bind the lessor to conduct "good faith" negotiations whether or not such is spelled out in the "Right." Provisions of this type usually include a date by which the lessee must opt to commence negotiations and a date by which the lessor is free to begin negotiating with others.

CONCLUSION

The conclusion that must be reached is that lessors' should avoid freely granting lease renewal options, as usually, they are not a very good idea. Renewal options are only of benefit to a tenant. They can cause some very complex and unanticipated problems in arriving at the future rental value. They do not enhance the value of the property or the owner's position. And, they may give the tenant an element of control over the future that may be unintended. There is no question that lessors are frequently compelled, by competitive pressures to grant renewal options. And, equally often, the lessor makes a business decision to undertake whatever risks the LRO may present because of the competitive pressures. The larger the tenant the greater the pressure on the lessor to provide inducements to the tenant when the rental market is highly competitive. However, in markets where the lessor is in the stronger position, inducements are unnecessary. And, where tenants are occupying small amounts of space there may be many reasons for avoiding LROs—not the least of which is providing for the possible expansion of other tenants.

If lease renewal options are considered by lessors, for whatever motivating reason, they should be very carefully thought out and negotiated as vigorously as any other material business terms of the lease. Treating lease renewal options as benign and customary may, in the future when the option is exercised, prove to be a very serious error for the lessor.$_{REI}$