

In the Spotlight

But for an Option, the Kingdom Was Lost

By Jack Garson

When I was just a young boy, my father sat me down and said, "Son, if you're going to rent, remember to get options to renew." And he added, "Don't be a sucker. Make sure those options are at a fixed rent." Actually, no. That conversation never took place. But there are millions of retailers and thousand of landlords who wish someone had sat them down and told them renewal options strategies. Over the past 25 years, I have seen countless retailers unable to maximize the value of their business, whether for sale or continued operation, because they did not have effective options in place to renew their leases. Likewise, I have seen landlords with grand plans for redevelopment of their property hamstrung by a tenant with a renewal option that blocked demolition of a critical building. Foresighted tenants with ample bargaining power insist upon multiple renewal options that dramatically increase the value of their leases. Right now, I have a lease on my desk entitling a tenant to 10 options to renew the lease for 5 years per option, all at predetermined, fixed rents.

GOOD DEAL, BAD DEAL

In this particular deal, with an anchor grocery store leasing approximately 70,000 square feet, at rents arguably well below market throughout all of the renewal periods, one can see a tremendous transfer of value from the landlord to the tenant. On the other

hand, the landlord needs the tenant to anchor the property and, therefore, perhaps these rents are not below market at all. Yet, the likelihood is that this lease probably can be auctioned off at some time in the future for hundreds of thousands — if not millions — of dollars given the multiple, below market rent renewal options. On another corner of my desk sit two leases that tell a far different story. One is for a dry cleaner with 3 years left on his lease and no options to renew. His deal to sell the dry cleaning business just fell through because the landlord refused to extend the lease, and the purchaser would not invest in such a short-term prospect. The second lease story is similar. A beer, wine, and deli operator wants to sell his store, but only has 2 years left on the term of his lease. The prospective purchaser requires 10 more years, preferably in two, 5-year renewal options. Again, no deal. The fundamental fact is that a lease provides a tenant with the opportunity to use the premises for a given time period, and during that time period the landlord is deprived of the ability to rent the premises to another tenant or pursue other alternatives. Landlords must be careful to ensure that the grant of renewal options will not unduly hamper future deals and development. Another lease on my desk illustrates this dilemma: A developer wishes to purchase the landlord's property. The landlord has leased the premises to a fast-food operator. Fortunately, the lease is about to expire. Otherwise, the landlord might be forced to reject a multimillion dollar offer for the sale of the property because the tenant's continued occupancy would kill the deal.

TENANT VERSUS LANDLORD EXPECTATIONS

Lesson: Careful decisions must be made when either party negotiates the terms of renewal options. Ideally, a tenant will obtain a lease with an initial term that enables the tenant to explore both the viability of the premises as a new business location, as well as options to renew if the tenant enjoys success. These options should be at predetermined



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rents, and the tenant should only be required to provide reasonable advance notice in order to exercise the options. There also should be no special conditions that the tenant must satisfy in order to renew, such as meeting a net worth test or forfeiting the options if the tenant desires to sell his or her business. Landlords, on the other hand, have little incentive to provide options to renew. Options to renew are, by their very nature, one-way streets benefiting only the tenant. The little incentive that landlords do have to give renewal options, however, is the fact that tenants insist upon them and really good tenants won't lease without them. In fact, landlords should consider that a tough, pro-landlord lease is a little bit like an intelligence test. If a tenant signs a very pro-landlord lease without appropriate revisions, the tenant fails the test and the landlord wins a bad tenant.

BE FLEXIBLE

Landlords should remember that they don't want leases that only tenants lacking in intelligence will sign. So, it is necessary to be flexible. What is an appropriate renewal option? First, to be realistic, one must always consider the relative bargaining power of the parties. Anchor tenants get a better bargain than, for example, any of the crowd of dry cleaners that are competing to lease the one available dry cleaning premises in a new neighborhood shopping center. While this is the topic of another column, the first lesson in any lease discussion is that each party should have alternatives in order to obtain bargaining power to negotiate the best available deal. Second, let's apply some rules of thumb. Generally, the landlord should not be providing more term in the form of options than the tenant is committing to in the initial term. For example, a tenant committing to an initial 10-year term should not get more than two, 5-year options. Also, the rent at the start of each option term should either be the prevailing fair market rent or a fixed rent that reasonably approximates the original rent increased by anticipated inflation. It is not uncommon in recent decades for the option rent to increase by 10-15% each 5 years for national credit tenants, and by 2 1/2-3% per year for other tenants, or even more if greater than normal inflation is anticipated. Again, tenants with greater bargaining power tend to obtain lower rent increases and vice versa for tenants without strong bargaining power.

NEGOTIATE FAIRLY

Landlords also should insist that the initial rent for each option term shall not be less than the rent for the last year of the immediately preceding term. This is often contested by tenants, but really should not be a big issue. If market rents are actually lower than the rent a tenant was paying during the last term, then the rental market has likely softened. The tenant can forgo the option and simply negotiate a better deal given the soft rental market. This is only a general observation, however. If the

tenant has made expensive alterations to the premises, or other similar factors apply, the tenant might appropriately insist on a true, fair market renewal option where the rent can go down, as well as up. Third, option terms are often the subject of tremendous negotiation and qualification. As alluded to above, many landlords do and should impose numerous conditions on renewal rights. At one extreme, some landlords will attempt to revoke the options in the event of the tenant's assignment of the lease. Fight this. Especially with a retail business, a primary motivation of the tenant is the prospect of growing and ultimately selling the tenant's business. Given that many purchasers of retail businesses are paying a purchase price equal to three to five times the tenant's annual net income in order to buy the tenant's business, the purchaser usually will require 8-10 years, or more, in order to amortize the purchase price and allow sufficient time to make a return on its investment. Without an ample lease term, by renewal or otherwise, the tenant cannot sell the business.

OPTION RENEWAL NOTICE

Landlords should impose other conditions on options, however, from the mundane to the exotic. Typically, the tenant should provide ample advance notice of the exercise of the option. This is necessary to allow the landlord time to re-let the premises if the tenant does not renew. Tenants must understand, however, the gravity of the notice requirement. If the tenant is late with an option renewal notice, the tenant will likely forfeit the option. While some limited exceptions exist, the applicable legal requirements generally favor forfeiture of the option where the notice is late. Indeed, courts have been increasingly comfortable confirming these harsh results. The typical renewal option will also require that the tenant not be in default at the time of exercise and/or commencement of the renewal option. Again, the landlord is justified

in imposing this condition to prevent continued occupancy by tenants who do not honor their obligations. More exotic requirements include lease provisions that subject the renewal option to termination (or relocation of the premises) in the event of demolition or renovation of the property or expansion by another tenant. In short, the landlord must prevent one tenant's renewal option from interfering with far larger transactions. The landlord might be considering a major redevelopment of the property, years in the making and subject to a variety of zoning, construction, financing, and market considerations.

BALANCE YOUR RIGHTS

Under these circumstances, the landlord should require the right to terminate the tenant's lease, notwithstanding the renewal option, if the landlord is able to redevelop the property and the tenant's renewal option would stand in the way. Rather than attempt to defeat the landlord's redevelopment plans, the tenant should attempt to negotiate a minimum guaranteed period of occupancy and possibly the right to relocate at the landlord's expense, or to rent space in the redeveloped property once completed or, failing either, payment from the landlord for the loss of the tenant's lease. Ultimately, a tenant should not be expected to forgo renewal rights that defeat the very purpose of entering into the lease. Nor should landlords be expected to grant renewal rights that reduce the landlord's overall return from the property — now and in the future. Each lease presents a balancing of the rights and obligations of both landlord and tenant. It is essential to understand how any right, whether an option to renew or otherwise, can impact your future success.

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