

**Legal Briefs**

# A Wise Compromise

Detailed analyses of lease renewal terms help establish fair-market rent.

by Anton N. Natsis, JD, and Michael E. McFadden, JD

A tenant is negotiating with a landlord to lease office space. The term of the potential lease is five years, but the tenant also wants the right to extend the lease for an additional five years. This situation is increasingly common in today's market. Office tenants often bargain for the right to extend the terms of their leases, since without renewal clauses, they may have to relocate at the end of their lease, incurring significant executive downtime, out-of-pocket expenses, and business interruption. In addition, without an express renewal right, the landlord could require the tenant to pay above market rent during the renewal term. To prevent this, tenants should attempt to negotiate renewal options at the fair-market rent for the space.

**Formulating the Renewal**

Renewal clauses focus on the actual formula used to calculate a fair-market renewal rental rate and the method used to determine the rate. Between these issues, the process used to determine the rate is at least as important as the formula

itself. As fair-market rents almost never are based on a set rental rate or a set inflation index, such as the Consumer Price Index, a process for determining the fair-market rate must be agreed upon and set forth in the lease. Throughout the arbitration process several significant issues must be addressed.

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**Exercise Date.** The deadline by which a tenant must exercise a renewal option is dependent upon several factors. First, the landlord should be informed well in advance if the tenant intends to exercise a renewal option. This allows the landlord time to find a third party to lease the space to if the tenant fails to exercise its option. The timeline

depends upon the size, type, and location of the space.

The general rule of thumb is the larger the space, the more notice landlords require. For example, typical standards dictate spaces between 5,000 square feet and 20,000 sf require nine months to 12 months prior notice; spaces between 20,000 sf and 60,000 sf require 12 months to 15 months prior notice; and spaces greater than 60,000 sf need 15 months to 18 months. If the tenant fails to notify the landlord in a timely manner, the renewal right terminates and the landlord can lease the space to another tenant.

**Negotiation Period.** If the tenant exercises its renewal option within the set time period, the landlord and tenant should meet to discuss and attempt to agree upon the fair-market rental rate for the space. Issues to consider include whether or not the tenant must irrevocably exercise its renewal option before the landlord is obligated to discuss fair-market rental rates, if the landlord is required to discuss fair-market rental rates with the tenant at any time, if the landlord is obligated to

provide back-up documentation of the fair-market rental rate determination, and the process to be followed if the landlord and tenant are not able to agree upon the fair-market rental rate.

Landlords often agree to discuss fair-market rents before tenants irrevocably have exercised their renewal option, provided a tenant exercises the renewal option before the landlord is obligated to proceed with any type of dispute resolution. With respect to back-up documentation, landlords generally consider the economic terms of other leases in the building to be confidential and are reluctant to turn over such information to the tenant. As a result, tenants are expected to rely upon their own sources to determine fair-market rental rates.

Finally, if the parties are unable to agree upon the fair-market rental rate within a set time period, such as 30 days, the lease must provide some mechanism for resolving the dispute.

**Dispute Resolution.** Landlords do not want to incur the time and costs of dispute resolution only to have tenants decide they are unhappy with the result and rescind the renewal option. Therefore, landlords almost always require tenants to irrevocably exercise renewal options before proceeding to any type of dispute resolution. The most common method of resolving a fair-market rental rate dispute is for each party to submit a final, binding fair-market rental rate determination to arbitration.

To arbitrate the fair-market rental rate, the landlord and tenant first must agree upon an arbitrator. This generally is done by each selecting their own advocate arbitrator, who usually is required to be a real estate broker, appraiser, or attorney with no less than five years of experience in the applicable space's real estate sector. Once the two advocate arbitrators have been selected, they meet and mutually select a third, neutral arbitrator who is responsible for determining the actual fair-market rental rate.

**Type of Arbitration.** During arbitration, the neutral arbitrator must select either the landlord's or the tenant's fair-market rental rate, but should not be allowed to select an alternative determination. Commonly known as baseball arbitration, this method was developed originally to resolve salary disputes between professional baseball players and owners. This approach is preferred over others because it tends to cause landlords and tenants to be more flexible in compromising. Each party knows that if its submitted rental rate is not closer to the rental rate that the neutral arbitrator believes to be the actual rental rate, then the neutral arbitrator will select the other party's submitted rental rate. As a result, baseball arbitration causes both parties to submit more realistic rental rates, and the process often results in the parties agreeing upon the fair-market rate without having to resort to arbitration, which saves both parties considerable time and money.

In today's marketplace, tenants often negotiate for and receive valuable renewal rights at the fair-market rental rate for the premises. To make such rights easily understood by both parties, landlords and tenants should ensure that a very precise process for determining the fair-market rental rate is set forth in the lease.

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