

Setting Rents During Option Terms -- The Market Rate Alternative

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Tenants typically want certainty in their expenses. Uncertainty in the cost of an operation, is the enemy of the budget process and impairs the ability of a business unit to achieve desired levels of profitability. Whether the tenant is a retailer, the branch or regional office of a major corporation, or a headquarters operation, predictability of expenses is very important. As leasing professionals, we try to assist tenants in bringing that certainty to operating results.

In the past, rent increases were based on increases in cost components, such as salaries of janitors. Then rents tracked the consumer price index and were readjusted at regular intervals. Rarely did retail or commercial rents get repriced from scratch over time, as is often the case with ground leases that run for a much longer term than the typical retail or office lease. Today, landlords and tenants frequently agree to steps in the rents so that both parties and the landlord's lender know exactly what the future rents will be. The initially agreed upon rental increases often end with the expiration of the base term of the lease. Not being able to look too far in the future, and not being willing to take the risk that the agreed rents will approximate rents then prevailing in the market, landlords with greater frequency are requiring that renewal rents be reset at market rates prevailing at the time of the renewal.

This is more easily said than done. When the parties are negotiating the lease at the outset, their negotiations set, or rather define, the market rental. Base rent is then established taking all factors into consideration, including the pending real estate economic conditions, the incentives given to induce the tenant to make the lease, the desirability of the premises, and most importantly, the going rate for premises of like kind. That open bargaining environment does not exist at the time of the renewal.

Frankly, the landlord often has the advantage in the retail setting. If the tenant wants to continue in business at the location, the direct and indirect cost to the tenant of moving can be extreme. The indirect cost of customer confusion and repositioning in a new market or slightly changed submarket can be high. Direct costs of relocation are not insignificant, even if some of those costs are contributed by the new landlord. Communications equipment must be set up, computers must be reinstalled, employees must be diverted from their usual work causing sales and productivity to suffer. These are but a few of the costs of not coming to agreement on the renewal rent.

From the landlord's perspective, the possibility of going through the leasing process with its share of uncertainty and the possibility of leaseable space standing unleased and not being revenue producing is also unappealing.

With these factors lying in the background, both parties should be motivated to come to an agreement on the market rate of rent. Unfortunately, they do not always do so. Occasionally the reason for their nonagreement is that they are not always motivated to reach a fair bargain. One may sometimes try to take advantage of the other. For this reason, the procedure set out in the lease to be utilized if the parties do not come to agreement is important. It must provide the working plan for reaching a fair resolution of the rental determination. Where this approach is taken, the lease must address a wide range of procedural issues to create a framework to fairly and efficiently deal with the concerns of the parties.

First, the definition of market rent must be agreed upon. Several factors must be taken into consideration in defining the market rate. While some leases often leave the whole process to chance, without being more definitive, sophisticated leases contain a high degree of precision in both the definition of the market rental rate and the procedure for the establishment of that rent. In defining what is meant by market rent, the area and type of the premises must be agreed upon. For example, is the rent for a Class A or Class B office building to be used in the case of an office lease, or is the rent for a retail strip center, big box retail center or a regional shopping center to be used in the case of a retail store property. Without the type of property being established, the identification of comparable properties may be difficult.

The factors to be considered in setting the rent should also be agreed upon. When leasing brokers quote prevailing rents, they assume certain factors will be included in the rents as set. Obvious factors include the amount of any tenant improvement allowance, free rent, brokerage and other economic factors that are included in the economic arrangements for a new lease. Other aspects of the agreement relate to the premises, for example, in an office building, higher rents may be charged for upper floors or the location on a floor. In a retail environment, the rental rate may change in relation to the visibility of the space in the center, and its proximity to high traffic areas or cotenants.

Once the definitional issues are agreed upon, the parties must agree upon the procedure for establishing the rental rate. The practical reality of the situation is that no matter what the lease says, the parties will communicate with each other to see if agreement can be reached. Frequently, the tenant's broker will contact the landlord in an attempt to come to an agreement on the lease rate for the option term. The lease should encourage if not require this natural meeting and agreement.

If the parties cannot agree, the lease should set up a mechanism for one or more neutral third parties to evaluate the market conditions and establish the rent for the option term. Typically, a provision will be made for one or more experienced parties to be called upon to determine what the applicable market rent shall be. Time must be provided for this process to work its way through to a proper conclusion. The process of selecting the third parties may take a considerable period of time. Indeed, the identification of the third party is very important in reaching a fair resolution. Neutrality is of course important, but equally important is the experience

and expertise of the arbiters.

Once the prevailing market rental rate is established, will that rate be binding on the landlord and tenant? From the tenant's perspective, the rate may be too much to bear, even if it is a fair reflection of market conditions. That rate may result in an unacceptably thin profit margin from operations. Tenants seek the right to rescind the exercise of the extension option to prevent that result. As a practical matter, this is a right that will not be exercised unless the determination of the arbiter is excessive. Moving a business is an expensive undertaking. A retailer cannot just give up a market unless the cost is prohibitive or an attractive alternative is available.

If the tenant is successful in obtaining this concession, the landlord rightfully needs the time to relet the space. This requires that the projection of the time to reach the determination must be set out on a time line against the time to time needed to relet the property. The process may be started a bit earlier than would be the case if the rent for the option term was set in the lease. If the rent determination procedure is projected to end with less than six months of term remaining, and the tenant successfully negotiates to obtain a rescission right, the landlord may want the lease term to be automatically extended for a short period of time so that a minimum of six to nine months of lease term will remain before the tenant's obligation ends. This will give the landlord time to market the property.

Following is a sample clause for use in situations of this kind.

As used in this Lease, the term "Market Rate of Rent" shall mean the prevailing annual rate of rent (determined on a "net" lease basis) per square foot of rentable area for space in the _____ and in comparable _____ located in the _____ market area, and which are comparable to the Premises, taking into consideration: the location, quality and age of the applicable _____; the use, size and floor level of the space in question; the method of determining "rentable area"; the extent of leasehold improvements to be provided by the landlord or tenant; the condition of the space in question; leasehold improvement allowances; abatements (including abatement of base rent, operating expenses and real estate taxes); lease takeovers or assumptions undertaken by a landlord; relocation and moving allowances; space planning and interior architecture and engineering allowances; refurbishment and repainting allowances; other concessions or inducements; the extent of services provided or to be provided; base years or dollar amounts for escalation purposes (both operating expenses and real estate taxes); any other adjustments (including by way of indexes) to base rental; the credit standing and financial stature of the Tenant; the term or length of lease; the time the particular rental rate under consideration was agreed upon and became or is to become effective; the payment of a leasing commission or fees or of bonuses in lieu thereof, whether to Landlord, any person or entity affiliated with Landlord, or to an unaffiliated person or entity; and other comparable factors reflective of the then current market for Tenants then leasing space of comparable area. Under this Lease, the Market Rate of Rent shall assume payments of Adjustment Rent as provided in this Lease. In

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making any determination of the Market Rate of Rent under this Lease, Landlord shall, within fourteen days after notice of Tenant's election to exercise an option to extend the term of this Lease, notify Tenant of the Landlord's proposed Market Rate of Rent for the Premises. Tenant shall have fourteen days after the receipt of such notice to accept or reject the Landlord's proposed Market Rate of Rent. If Tenant rejects Landlord's proposed Market Rate of Rent, Landlord and Tenant shall, within ten days after demand therefor by one or the other of them, meet at the Premises through persons with the authority to decide the matter, in an effort to agree upon the Market Rate of Rent. If no agreement can be made at such meeting, the determination of the Market Rate of Rent shall be made by a single arbiter who shall be selected from a list of six arbiters proposed by each of Landlord and Tenant within fourteen days after such meeting, or if no such meeting was held, within fourteen days after demand by either Landlord or Tenant. Such arbiter shall have not less than ten years of experience in the rental of _____ comparable to the _____ in the _____ area. If the parties cannot decide upon the arbiter, the arbiter will be selected from the list proposed by Landlord and Tenant or if only one of the parties has submitted such list, then from the list submitted by such party, by the _____. The arbiter shall determine the Market Rate of Rent for the Premises guided by the principles of good faith and fair dealing and report such determination to Landlord and Tenant within thirty days after appointment. If Tenant does not agree with the arbiter's determination of the Market Rate of Rent, Tenant may, within fourteen days after the receipt of the arbiter's determination, rescind the election to extend the term of this Lease for the applicable option term. If Tenant does so rescind, and at the time of such rescission there are less than ____ days remaining in the initial or any then pending renewal Term, such term shall be extended automatically without further action of the parties to the date that is ____ days after the effective date of such rescission. If Tenant does not so rescind, the arbiter's determination of Market Rate of Rent will control.