



Beyond the Basics: Drafting Effective Option Provisions in Commercial Lease Agreements

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It is not uncommon in commercial leases for tenants and landlords to negotiate renewal options in the initial lease. For a tenant, a renewal option allows for a higher degree of certainty about future occupancy: this in turn bolsters its decision to invest in that location. For a landlord, a renewal option, while not a guarantee of future rents, provides a greater likelihood of continuity of occupancy. Further, if drafted correctly, a landlord has sufficient time to find a new tenant if the option is not exercised.

In this third installment of the “Beyond the Basics” series (read the first and second posts here) we will discuss some of the best practices in negotiating and documenting commercial lease renewal options.

Does a Tenant Have the Right to Renew a Lease?

In Michigan, a commercial tenant has no express or implied right to renew a lease. *Briarwood v Faber’s Fabrics, Inc*, 163 Mich App 784, 415 NW2d 310 (1987). Options are governed by the contract terms established by the parties and documented in a lease or option agreement. *Phillips v Homer (In re Smith Tr)*, 480 Mich 19, 28, 745 NW2d 754 (2008). An option to extend or renew is treated as a continuing offer by the landlord which must be exercised. *Maas Bros v Weitzman*, 288 Mich 625, 286 NW 104 (1939). When accepted by the tenant, the option becomes a binding contract to lease during the extended period.

In light of the case law, which expresses Michigan’s public policy against granting tenants implied or express rights to renew commercial leases in the absence of a contractual agreement, it’s important for the parties to negotiate and document the terms in advance. From renewal rates to procedures related to exercising an option, there are a number of issues that tenants and landlords must consider to protect themselves and clarify the understanding of an agreement that may not become effective for many years.

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Best Practices in Drafting Effective Option Provisions

1. Set forth the specific manner in which to exercise the option. A lease agreement should clearly spell out the means by which an option may be exercised. For example, how far in advance must a tenant provide notice to a landlord? Is written notice required? If so, must the notice be provided via first class mail or is an email sufficient? The Michigan Supreme Court has held that strict compliance with lease renewal option terms is required. In *LeBaron Homes v Pontiac Housing Funds*, 319 Mich 310, 313; 29 NW 704 (1947), the Supreme Court explained that:

An option is but an offer, strict compliance with the terms of which is required; acceptance must be in compliance with the terms proposed by the option both as to the exact thing offered and within the time specified; otherwise the right is lost (internal citations omitted).

2. Extensions vs. renewals. A lease should make clear whether a tenant has the option to either “extend” or “renew” the lease. While this may seem like an academic exercise, the difference between an extension and a renewal is important. While an extension extends the term of the existing lease, a renewal contemplates that parties execute the lease over again. If the landlord has granted concessions such as free rent, a renewal may revive those concessions.

3. Set forth a specific way in which rent is to be calculated for the option. An effective option to renew provision should set forth the parties’ agreement as to the amount of rent to be paid by the tenant, or at least set forth a procedure for determining an amount. An “agreement to agree” at a later date is generally not sufficient and can lead to litigation and/or the option being declared void. When negotiating future rent, the parties can decide upon a fixed amount in advance, or designate “market rent” with an agreed-upon manner for determining it. The parties can also include floors or caps if the rent is not fully agreed to in advance to guard against major up or down swings in market prices.

4. Condition the option on tenant’s performance of the lease. Most landlords would prefer not to allow a defaulting tenant to exercise an option; therefore from a landlord’s perspective, it may be important to include language that conditions a tenant’s ability to exercise an option to renew on the tenant’s prior performance of the lease. This can range from a provision that requires a tenant to not currently be in default to one that provides that tenant must never have been in default. A hybrid approach could require a tenant to not currently be in default, nor have been in default within a certain number of years.

5. Limit who can exercise the option. Commercial leases should contain clauses addressing the parties’ ability to assign the lease. If a lease allows a tenant to assign its rights, a landlord may want to limit any option to renew to the original tenant and not its assignee. In a similar vein, a “change of control” provision can protect a landlord from an end-around where a tenant sells the stock/membership interest to another party to which a landlord may not want to contract with.

6. Material change in financial condition. As a condition of exercising an option, landlords may consider requiring a tenant to submit updated financial statements. The goal of this is to determine if there has been a material financial change from the inception of the lease which could be an early indicator of a future default.



However, parties should take care in defining what constitutes a material change in financial condition, as a lack of clarity can render an option invalid. At minimum, the parties should clarify who has the burden to show either a material change (landlord) or the absence of one (tenant).

Conclusion

Options to renew can benefit both tenants and landlords; however, they require careful negotiation and drafting to ensure against unintended consequences. If you are a landlord and would like to know more about best practices in drafting options in commercial leases, along with other related topics, contact Rob Hamor at 248.785.4737 or at rhamor@fosterswift.com.

