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Monthly Q&A

September 15, 2008 - Long Island

Q: Our company is negotiating a long-term lease for a new manufacturing facility. How important is an option to renew or purchase?

A: The definition of an option is a provision in an agreement that gives one party the right, but not the obligation, to exercise a right of some kind. This is important to keep in mind when negotiating tenant options in a lease. A tenant option gives the tenant the right, but not the obligation, to renew, to purchase, to expand or to perform some other action. If and when a tenant exercises this right, the landlord must comply. Thus, all things being equal, it behooves the tenant to negotiate as many options as possible. It is to the landlord's advantage to negotiate as few tenant options as possible.

One ordinarily thinks of an option being a tenant prerogative, but in fact, landlords may also have options, such as the ability to terminate the lease or relocate a tenant. In any case, the advantage always goes to the party that may exercise the option.

From a tenant point of view then, the best strategy is to negotiate as many options as possible.

Here is a key point: Since an option is almost a future event, and no one has an accurate crystal ball, a tenant is always better off taking what seems to be a worthless option than no option. If negotiation with your landlord yields only an option to purchase at what seems a ridiculous price, take it. If the price is above market at the time that the option may be exercised, you will ignore it, and offer to negotiate with the landlord. But if it is below market, you may exercise it and the landlord has no recourse. Thus options are sometimes labeled "a one-way street."

So why would a landlord offer an option? Options are market driven. In a strong sellers' or landlords' market, options may be dear and expensive. In a high vacancy market, landlords will use options to create incentives to lease. Landlords are often very uncomfortable in providing options at a fixed cost, particularly many years into the future. Thus it is common to see "fair market value" options. These are options that allow a tenant to renew or purchase at a price that is supposedly at fair market value when the option is exercised. This, of course, requires some ingenuity on the part of the landlord and tenant in agreeing on the definition of fair market value. You should also be aware as a tenant, that a landlord has considerable cost savings in renewing your lease as opposed to finding a new tenant. A new tenant may require costs that include additional brokerage and construction, not to mention vacancy and the associated lost rent. So it is common to see renewal options set at some percentage of fair market value, such as 90%.

Because you are negotiating a lease for a manufacturing facility, I would assume that there will be significant capital expenditures on your part that need to be protected with a long term lease or, perhaps, an eventual purchase. Landlords of such facilities are usually aware of your needs, and would be unable to lease their buildings without providing their tenant the right to amortize heavy capital outlays. Thus the negotiation of options is vitally important in your situation.

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