

HOW HARD CAN IT BE TO EXERCISE A LEASE RENEWAL OPTION?

BY: Joshua Stein¹

If a commercial tenant knows its lease will end soon, but it wants to stay in place longer on favorable (or at least known) terms, this often requires nothing more than properly exercising a renewal option in the lease. Especially if the option is below market, failure to exercise it correctly means the tenant may have to pay dramatically more rent, or even go out of business. So you would think when a tenant has a renewal option and wants to keep its location and wants to renew, it would properly exercise that option.

Not always.

In a recent reported litigation, the tenant had a five-year renewal option and had subleased its space to a third party, giving the subtenant an equivalent renewal option. The subtenant wrote a letter to the tenant exercising the subtenant's five-year option. The tenant gave the landlord a copy of the subtenant's letter exercising its option. The tenant and the landlord had a nice telephone conversation. The landlord said it would be okay for the tenant to renew and the tenant could fax an exercise notice to the landlord. So the tenant faxed to the landlord another copy of the subtenant's exercise notice.

After the tenant's deadline to exercise the option passed, the tenant apparently talked to a lawyer, panicked, and sent the landlord a formal notice that the tenant had renewed the lease. The landlord rejected that notice as untimely, and signed a direct lease with the former subtenant.

Did the tenant properly exercise its renewal option? The trial court, the court that first heard the litigation, decided it was enough for the tenant to have sent the landlord a copy of the subtenant's renewal notice. This communication adequately conveyed the tenant's desire to renew, the court declared. The tenant didn't need to do anything more.

When the landlord appealed that decision, the appellate court sided with the landlord. The tenant's communications with the landlord had no connection to the tenant's lease. All they addressed was the sublease. The tenant never formally stated it renewed its lease. Instead, the tenant just sort of implied it. So the tenant was out of luck.

The court acknowledged this might be "harsh," but said "commercial certainty" requires courts to enforce contracts, including leases, as written. This contract required the tenant to give notice of renewal. Instead, the tenant gave a notice that just indicated someone else had renewed some other occupancy arrangement.

One way to look at this dispute is to ask what would have happened if, after the same history, the landlord had tried to enforce the lease renewal against the tenant. Could the landlord have asserted that the tenant had renewed, so was on the hook for five more years? If the landlord had asserted that, the tenant could well have avoided liability, because the tenant never actually gave the landlord a document exercising the renewal option. If that's really what the result would have been had the landlord sued the tenant, then it does seem only logical that the same result – the lease was not renewed – should also apply in the reverse.

For any tenant, this litigation obviously teaches the lesson that it might pay to consult counsel when trying to exercise a valuable right. And if the tenant was originally advised by a broker and by counsel in negotiating the lease, then both of those advisers passed up a valuable client service/retention opportunity by failing to reach out to the tenant a few months before the exercise deadline, to help assure the tenant exercised the option correctly.

Cases like this one arise all the time. Courts aren't always as harsh on tenants as this appellate court was. Sometimes the courts say they don't want the tenant to suffer a "forfeiture." Other times, probably more often, they say an option must be exercised strictly in accordance with its terms; otherwise it's gone.

For retail tenants in today's environment of high vacancies – leading to lower rents, either now or soon – a renewal option isn't necessarily as valuable as it might have been to the tenant in the litigation described above. That's because renewal options often say the renewal rent can never be lower than the pre-renewal rent. A tenant stuck with such an option may still have sound business reasons to exercise it, hence must start by understanding its terms and exactly how to exercise it. But any such tenant also should open a conversation with the landlord long before the exercise deadline. That way, the tenant avoids painting itself into a corner where its only way to assure continued occupancy consists of correctly exercising an unappealing option.

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