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Client Alert

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Market Value - No Bull, Your Market Rent Determination Language Could Be (Legally) Unbearable

We've all seen the "market rate" renewal option concept. One day, down the road, if the tenant elects to renew its lease, the parties will reconvene and the rents payable for the renewal option will be mutually determined.

With rare exception, to a landlord a market rate renewal option is preferable over specifically stated rents, as a market rate renewal option effectively mitigates the landlord's risk that specifically stated rents may, when the time comes, be well below the actual market rent. A market rental rate gives the landlord security that it won't be stuck in a below market lease.

To a tenant, as a worst-case-scenario, all renewal options are inherently at market rate. If a lease contains stipulated rental rates for a renewal option that are below market at the time of exercise, the Tenant will do a straight exercise of its renewal option to get the benefit of those pre-negotiated rental rates. On the other hand, if a lease contains stipulated rental rates for a renewal option that are above the then-existing market rates, the tenant will approach the landlord about renewal and request that the pre-negotiated rates be re-negotiated to rental rates reflective of actual market conditions.

To ensure that all parties get their fair share in a turbulent market, agreeing to a market rent renewal option has seemingly become a safe call. However, on almost a deal-by-deal basis, the drafters of these market rent determination clauses have chosen to address them differently. Some try to sum up the process for market rent determination in one sentence, while others find a way to go on and on, for pages and pages, to define the market rent determination procedure in forest-clearing detail.

While the diplomatic lawyer might say that there's no one right way to do it, and it's each to his own style, with regard to market rent determination language, that's simply not the case.

When I take stock and think back to my first year of law school, I can still hear my contracts professor screaming in an almost stereotypical fashion, "no, no, NO, agreeing to bargain later would be unenforceable! It's an agreement to agree!" And maybe you've heard someone say that in the course of your own negotiations. Well, even after all these years, my contracts professor remains correct. Leases are contracts, and failing to spell out how market rents will be determined in sufficient detail may, in fact, render a fair market renewal

option right entirely unenforceable. Merely stating that a renewal option will be at market rent as then determined by landlord and tenant is an agreement to agree and likely null and void.

Tenants should be especially concerned as to whether a lease's market rent determination language states the procedure for determining market rent with sufficient specificity to keep it from being rendered meaningless. In theory, landlords shouldn't care whether a lease's renewal option is enforceable, as renewal options really only benefit the tenant. Yet, as is often the case, it's the landlord that gets the first stab at drafting the market rent determination language. And often times, the tenant will just accept it, no matter how simplistic.

So what's the take away here? When a landlord presents to a tenant some market rent determination language, a tenant should always invest some time to ask itself whether the language sufficiently defines a determination mechanism so as to keep it from being an unenforceable "agreement to agree." What does that mechanism look like? Well I certainly don't want to bore you with a bunch of cites to the seminal case of _____ v. _____, so I'll reply with an equally lawyerly, "it depends." But I'll guarantee to you that the answer lies somewhere between text as lengthy as a 2007 ICSC ReCon attendee list, and the following: "Market rent shall be an amount to be agreed upon by Landlord and Tenant at the time Tenant exercises its option to renew." To be perfectly clear, both the former and the latter are bad methods of handling market rent determination language, each for their own varying reasons. Enforceable language should concisely detail a specific process for determining market rent, and should always contain a stipulated remedy if the parties are unable to agree, such as arbitration with retained and independent brokers.

And why should tenants care so much? Many tenants amortize their deal costs over the initial term and option terms of a lease. If renewal options are deemed to be unenforceable, suddenly a tenant may find itself attempting to amortize costs over a period of time that is half of the time originally anticipated. Further, many franchise agreements require franchisees to enter into leases with a potential minimum life twenty years. If this is structured as a ten year lease with two five year options, upon the disappearance of two unenforceable options, a franchisee can quickly find itself in default (albeit technically) of its franchise agreement.

Take the bull by the horns and ensure that your market rent determination language is sufficiently hashed out. It may not be the most fun exercise, but sometimes you just have to grin and bear it. A tenant shouldn't allow flimsy market rent language to put its back against the wall. Street language simply won't suffice. Taking the time to draft a legally enforceable market rent provision will always pay dividends.