How To Stay Away From The Minefields In Lease Expansions, Extensions, And Renewals

Joshua Stein
is the sole principal of Joshua Stein PLLC, a New York City commercial real estate law practice. A member of the American College of Real Estate Lawyers and the Anglo American Real Property Institute, the author has written five books (two of them published by ALI-ABA) and over 200 articles on commercial real estate law and practice. For more information on the author, visit www.joshuastein.com. The author acknowledges with thanks the editorial contributions and comments of Leah R. Fang, who worked with the author at Joshua Stein PLLC and at his previous firm; Charles L. Brutten, an attorney who works at Joshua Stein PLLC; Robert J. Gorrie, Pace University School of Law, Class of 2012; Alfredo R. Lagamon, Jr., of Ernst & Young; and Donald H. Oppenheim of Berkeley, California. Blame only the author for any errors.

Joshua Stein

Changing an existing lease can be trickier than you think.

WHEN A LANDLORD and a tenant want to expand, extend, or renew an existing lease, they often think it's as simple as "pushing a button" to document their transaction. It isn't. These transactions are tricky, creating all kinds of opportunities for error and surprises. This article will refer to lease expansions, extensions, and renewals collectively as "lease amendments." Though they're not as much work as negotiating a new lease from scratch, lease amendments do require turning over lots of stones and asking lots of questions.

GET THE DOCUMENTATION • Before you can start to document any lease amendment, you first need to know what the existing lease already says. What documents already exist? Collect all existing lease documentation, and look at it closely. Don't just look at the original lease and any prior amendments. Are there any related documents you need to consider? A guaranty? A nondisturbance agreement? Letters that significantly affected the relationship between the parties? Any disputes that have already arisen about the terms of the lease?

Recording The Amendment

The lease file might include a memorandum of lease that the parties recorded. The parties may, in occasional

cases, have even recorded the entire lease. In either event, today's amendment should mention what was recorded. And if the original lease (or even just a memorandum) was recorded, you will usually need to take the extra step of recording the entire lease amendment, or at least a memorandum giving notice of the lease amendment.

Do You Need Consents For The Amendment?

Any lease amendment may require consents from third parties. The landlord will almost always have a lender. Occasionally, the "landlord" will really be a tenant, holding only a leasehold estate under a long-term ground lease from the fee owner. Either of these documents may require the landlord to obtain consent to any future lease amendments, depending of course on the specific terms of the third-party documents.

Even if no agreement between the landlord and the lender (or the ground lessor) specifically requires lender approval, ask whether the tenant entered into a nondisturbance or recognition agreement with the lender or the ground lessor. If that happened, then the agreement will usually say that the lender or ground lessor won't be bound by any lease amendments made without its consent. Thus, even if the landlord hasn't directly agreed to seek this third party's consent, the nondisturbance or recognition agreement will effectively require such consent, producing the same practical result.

If you see you will need a third-party consent, start the process of obtaining it as soon as possible. It may require lead time, or non-obvious documentation or procedures. Does any document describe the process or limit the third party's discretion in consenting to lease amendments? For previous transactions, how did the process work, and how long did it take? Will the third party consider a proposed transaction based on a term sheet or an informal email inquiry, or will they insist on doing nothing until they receive signed documents? Counsel should answer those questions early in the process, and then proceed accordingly.

Look For The Brokerage Agreement

The lease file may contain at least one brokerage agreement, and very likely two, for the original lease. If it doesn't, you should ask why not, and try to find a copy of any brokerage agreement(s) that exist. Any brokerage agreement may say that the broker can collect a further commission if landlord and tenant enter into certain lease amendments. Sometimes, the broker(s) who negotiated the original lease will remain in the picture at the time of the lease amendment and participate. In other cases, one or another broker is no longer involved, but the agreement may still award them a supplemental commission on the lease amendment. In the worst case, no one can find the brokerage agreement, and no one knows the rights of the broker(s). Once again, this possibility — which is hardly hypothetical — demonstrates the importance of collecting all documents for any transaction in one logical place, where they can be found years later. That principle applies with special force to leases, given their long life expectancies.

IS IT A NEW DEAL? • Once you have all the original documentation for the existing lease, you need to ask whether today's transaction is an entirely new deal never contemplated under the original lease, or whether the tenant already had a renewal or extension right under the existing lease, and is merely exercising it.

Is There A Process For Exercising An Expansion Or Extension Right?

If the lease already contains an expansion or extension right, the lease will sometimes contain very specific provisions on how and when the tenant can exercise that right, and what happens if the tenant does so. If the lease does that and the tenant merely exercises its rights under the lease, the necessary

documentation to confirm the lease amendment can consist of a one-page unilateral letter from the tenant to the landlord. In that case, however, the tenant must take care to comply with the specific requirements of the lease, or the tenant's exercise of its rights may not be valid or effective.

If the lease contemplates a process to determine fair market rental value for a renewal or expansion term, the procedures can as a practical matter turn out to be rather sticky and complex, even if they sounded quite simple in the lease. Whether you represent landlord or tenant, you should advise your client to focus on the rent determination process as early as possible. For example, if your client anticipates an appraisal process ahead, your client may want to engage a preferred appraiser before the other party does.

For some suggestions on how a tenant and its counsel can successfully navigate some of the minefields of exercising renewal rights and determining "fair market" rent in any renewal term, see Joshua Stein, *A Checklist for Giving Legally Effective Notices,* The Practical Lawyer, August 2005, at 11.

Even if the tenant merely exercises a renewal or expansion right expressly provided for in the lease, both landlord and tenant may want to memorialize the resulting changes in the lease in a separate lease amendment. In that case, all the suggestions in this article would apply.

Document Any Deviation From What The Amendment Permits

In many cases, although the lease gives the tenant a specific renewal or expansion right, the parties will end up agreeing to do something else. At a minimum, instead of enduring a rent appraisal process, the parties will often agree on the rent. Instead of renewing for five years, the tenant may want to renew for seven; the landlord may accommodate. The parties may agree to tweak the escalation clauses. And they may, in any number of other ways, proceed in a way that's not exactly what they had in mind years before when they negotiated their lease.

In many cases, the original lease did not contemplate expansion or renewal, or may have addressed the topic in a sloppy, incomplete, or minimalistic way. This can occur when the tenant never saw value in having rights of this type, or if the landlord didn't really want to grant them.

Some landlords try, as a matter of policy, not to include extension or expansion options in their leases. They reason that they may be in a better bargaining position when the lease term expires and don't want to agree to any rights that extend beyond the initial term. Landlords may also value the future flexibility that they retain by not having to reserve space to accommodate future contractual extension and expansion rights.

DOCUMENTING LEASE AMENDMENTS • In documenting any lease amendment, the issue of first and most importance to the parties will be the rent payable under the lease amendment. In most significant leases, the parties' brokers will agree on the rent as part of a negotiated term sheet. The term sheet will state whether the landlord must give the tenant a new "free rent" period and whether the landlord will give the tenant a new tenant improvement allowance. The term sheet, which is something lawyers are not often involved in negotiating, will also likely include important items such as base years for escalations, and perhaps changes in tenant's share of expenses above the base.

The final term sheet goes to counsel as a rough guideline for drafting the lease amendment, usually accompanied by statements that:

- It's a very simple transaction;
- The parties want to get it signed up as quickly as possible; and
- They have already been negotiating the transaction for, e.g., an entire year, so this makes it all the more important to sign as quickly as possible.

If landlord and tenant negotiated the lease amendment outside of the four corners of the existing lease, counsel might be tempted to start from scratch and create an entirely new lease. In most cases this is a waste of time (and expense for the client), unless the existing lease is truly antiquated and inadequate. Any specific identified mistake or omission can be dealt with in the amendment, which will ultimately be shorter and simpler — less expensive — than drafting an entirely new lease. A new lease will also open up a Pandora's Box of lease issues that otherwise probably never would attract anyone's attention. Most likely, both landlord and tenant will prefer to just amend their original lease — for better or worse — particularly since that's how everyone else generally does it. Unless there is an overwhelmingly compelling reason to prepare an entirely new lease, counsel should stick to the amendment format to memorialize the new deal.

Any lease amendment must start by accurately handling every point mentioned in the term sheet. If counsel misses or misinterprets even one provision in the term sheet, this is a great way to antagonize — and lose the confidence of — everyone involved the deal, including your own client.

From counsel's perspective, the broker's most important job will consist of reviewing the business terms in the lease amendment to confirm they accurately reflect the term sheet, which may have been written in a more abbreviated way than a formal lease amendment.

Doing justice to a term sheet in a lease amendment is not as simple as cutting and pasting. Also, even before the tenant sees the first draft of any lease amendment, the landlord's broker should review the lease amendment. Rental rates and precise adjustment dates are hot buttons in any amendment.

Rent Terms

Does the rent always go up on the first day of the month? Or does it go up on anniversaries of a particular date, regardless of the day of the month that date occurred? And is the "base" date for these adjustments the commencement date of the lease or the rent commencement date? If the term sheet doesn't fully answer these questions, counsel must ask them and insist on obtaining answers.

The original lease may contain detailed provisions on expansion rights. These provisions may include a definitive rental rate (or a process for determining rent), the size of the expansion premises, whether the base years for taxes and operating expenses will change, and the termination date of the expansion premises, typically coterminous with the original premises. Here, your main responsibility will consist of memorializing the details of today's transaction in a lease amendment, and understanding whether the parties somehow varied from what the lease originally contemplated.

Whether or not a broker is involved, make sure your client carefully reviews the provisions on rent and escalations. They are perhaps five percent of the verbiage in any lease, but they represent 95 percent of what matters.

One way to clearly draft the rental section is to create a grid that includes the time periods and the rental for each time period using specific dates. If the commencement of the payment of rent is a contingent date, you can assume a certain date. If you do that, you should explain what you're doing as part of the lease language, and also include a provision saying the parties will adjust the dates in the rental grid once the lease has been executed or the rent commencement date determined. In that case, the commencement date letter would include an updated grid for rent rates and dates.

The "rental grid" approach with specific dates makes the economics of the lease amendment far more comprehensible to counsel, brokers, and their mutual clients, thus reducing the likelihood of mistakes. By making the economic terms easier to understand, you make them easier to check, because you don't waste a lot of the reader's brainpower on decoding them.

You should, however, still read through the entire lease and related documents to make sure you don't miss anything relevant to the lease amendment. Simply reviewing the expansion right section in the original lease without further investigation can invite trouble.

USING AMENDMENTS TO SOLVE PROBLEMS • Going beyond the economic terms of the term sheet and the words of the original lease, any lease amendment can also be used to adjust the relationship — solve problems — between the landlord and the tenant. It can give both parties a chance to repair mistakes in the original lease or its administration. Sometimes the lease amendment process will itself focus attention on these mistakes.

For example, in one lease amendment the author handled, the parties had miscalculated the expiration date of the original lease. Both parties simply had the wrong date. As part of the amendment, the parties corrected their mistake. (The problem arose because the original lease treated the commencement date and expiration date in a way that was almost incomprehensible. It came as no great surprise that no one had properly comprehended it.)

Issues may have arisen about either landlord's or tenant's obligations under the original lease. Perhaps landlord did not complete its construction obligations or fully disburse a tenant improvement allowance. The lease may have required the tenant to perform certain maintenance that it has never actually performed — or that made more sense for the landlord to perform — and the landlord actually did the work.

For example, one retail landlord represented by the author had experienced a number of problems with the tenant during the initial term. The tenant was quite desirable, but also badly wanted to keep this particular location, and had no contractual renewal right. Both parties had some degree of leverage. The landlord's problems with the tenant did not relate to payment of rent, but instead related to practical considerations such as use of basement space, storage of trash, lighting, scheduling of deliveries, and other operational matters.

As part of the lease amendment negotiations, the landlord asked for changes in all the provisions of the lease that had proven inadequate to deal with these practical issues. The tenant didn't agree to everything the landlord wanted, but did agree to most of it. The likely result: a more satisfactory landlord-tenant relationship during the renewal term — assuming the parties pay any attention to the words of the lease going forward.

One particular lease required the tenant to perform certain maintenance obligations. The tenant hadn't bothered to comply during the initial term. To avoid municipal penalties, the landlord performed the tenant's obligations, but never notified the tenant of its default. The original lease did not adequately address tenant's maintenance obligations and the consequences of tenant's non-performance, i.e., landlord's rights and remedies. As a result, the subsequent amendment revisited the section on maintenance obligations and set up consequences for the tenant's non-performance in certain circumstances. Because the maintenance obligations under the lease were supposed to be picked up by tenant, its counsel did not push back.

These various examples teach the same lesson. A landlord can and should use a lease amendment to revisit the existing relationship, and think about whether anything needs adjustment or repair. In many cases, the same areas of concern in these examples will raise concerns for other landlords.

Lease amendments can clear up these situations by rethinking them as necessary. If the terms of the original lease need to be reaffirmed, the lease amendment can do that. By specifically addressing these obligations, the lease amendment prevents future disputes, underscores what the parties really expect, clarifies the parties' obligations, cleans up

messes, and prevents claims of waiver that might otherwise arise.

Regardless of which party you represent in a lease amendment, ask whether anything about the leasing relationship to date has proven unsatisfactory and might merit change or correction. If so, now is the time to change or correct it. Of course, that approach may complicate and draw out a lease amendment that could otherwise be quite simple. The client will have to decide whether those costs are worth the benefits. It amounts to a business decision.

If the landlord and tenant have had disputes about anything — or if any disputes are underway at the time of the lease amendment — the lease amendment may give both parties an opportunity to resolve their dispute and prevent it from recurring. In the alternative, if the parties want to leave it open, they should expressly say so, to avoid any surprises about unintentional waivers or releases of claims.

Whether a lease amendment merely addresses a few economic terms or makes wholesale adjustments in the relationship between the parties, write any amendment in an organized manner. Usually this means following the same order as the original lease. Delete lease or prior amendment provisions that no longer apply and may cause confusion in the new amendment. Modify specific provisions of the original lease where necessary. In some cases, you may want to incorporate by reference certain provisions from the original lease and in other cases, for clarity, you may want to restate an entire provision, for example if the amendment process would otherwise become very complex and intricate.

HOW TO DRAFT AMENDMENTS • Usually, it doesn't make sense to write a lease amendment in a conceptual way — i.e., addressing a few topics in whatever order counsel wants to cover them, memorializing the agreement of the parties without referring to the terms of the original lease. This approach creates a high risk of interpretational problems, inviting the parties to disagree on whether some "concept" addressed in the lease amendment did or didn't change something that appeared in the original lease.

For example, if the original lease defined the "Scheduled Expiration Date" and the parties agree to extend the lease term by 10 years, they shouldn't just say "we hereby extend the lease term by 10 years." The drafter of the lease amendment should go in and surgically adjust the "Scheduled Expiration Date" by making it 10 years later. Otherwise, the parties leave open potential debate over whether the lease amendment actually changed the "Scheduled Expiration Date" and any rights and obligations that the "Scheduled Expiration Date" may trigger.

Any lease amendment should clarify whether any expansion or renewal rights in the original lease continue to apply. Usually, they shouldn't. In such cases, the landlord's counsel should drive a stake through their heart by deleting them. But what happens if the lease gives the tenant further expansion or renewal rights? Clarify that those continue, and only delete the option rights being exercised or superseded. Do the parties need to adjust the future option rights to take into account the lease amendment they sign today? If so, make the adjustment.

Make the lease amendment as specific as possible while still adhering to the original lease as much as possible. In the case of an expansion, the definition of "premises" under the original lease may or may not change. You may find it's easier to leave the "premises" alone and define a new and separate "expansion premises," with different economic terms. This approach will typically make sense if the expansion premises:

- Requires the tenant to pay a different rental rate than the original premises, perhaps with different scheduled increases;
- Has different escalation formulas; or

- Uses the same formula but different base years.

If you find that even one of the foregoing circumstances applies, having a separate definition — with separate economic terms — for the "expansion premises" will create less confusion in the future. The amendment will, of course, then need to include new economic definitions for the expansion premises, such as rent, tax base years, and operating expense base years. For everything else, the lease should say the expansion premises are governed by the same lease provisions that govern the original premises.

Any lease amendment may also need to address construction and tenant improvements. Will the landlord provide either of those for the new space or the extension term? If not, the lease amendment should make that clear, to prevent any argument by implication or inference. If the landlord will in fact provide either of these benefits, the terms of the original lease on those subjects may make sense for the lease amendment, but they also may not. Adjust them as appropriate. Deal with the issue one way or another. Silence is not good.

If the landlord obtained a guaranty of the original lease, then the landlord should insist that the same guarantor, or a satisfactory replacement, guaranty the lease as affected by the lease amendment. Absent an express confirmation from the guarantor, the landlord may find that the lease amendment eliminates the guaranty.

Conversely, if the original lease contained an exculpation or nonrecourse clause benefitting the landlord, the lease amendment should reaffirm that concept.

Counsel also needs to think about possible issues created by past and present leasing brokers. In major office building deals, brokerage agreements and commission payouts often deal with the possibility of unanticipated renewals or expansions. Sometimes, commission payouts for deals not expressly contemplated in the original lease apply only when the original broker remains actively involved in negotiating the amendment.

Counsel should, as noted above, ask the client about brokers early in the course of the transaction, especially if you are representing the landlord, as the landlord is generally the party who pays the brokerage commission. Your client will not be happy to discover a brokerage commission on top of the attorneys' fees incurred for the amendment.

If a broker is involved, and there is an existing brokerage agreement (assuming the same broker(s) is involved), counsel should consider drafting a new brokerage agreement or letter agreement that specifically deals with the commission due under the amendment. This amendment will clarify the amount of the commission and when the payout will occur. And if no existing agreement applies, the landlord will want to sign a new agreement with the broker about their commission.

To prevent future debates, try to express any commission as a specific number of dollars instead of a formula with inclusions and exclusions inviting debate and disputes over interpretation. The brokerage agreement should expressly include or reaffirm provisions in the original brokerage agreement, such as a broker's indemnity and restrictions on publicity and disclosure.

A broker's involvement can help counsel, as a broker can readily provide answers that the client may not be able to provide quickly. Brokers may help negotiate the lease amendment. Brokers can be especially helpful when they have intimate knowledge of the space and practical questions arise, such as when a client wants to expand and will need additional riser space, air-conditioning units, back-up generators, or the like. A broker who knows the building well can help counsel understand the building's systems and whether a tenant's requests can even be accommodated.

Counsel should, however, keep in the back of their mind the fact that brokers usually don't get paid unless deals get signed and closed. In the au-

thor's experience, however, this fact does not seem to warp the judgment and advice provided by reputable brokers.

CONCLUSION • Once landlord and tenant finalize and sign their lease amendment, make sure that both lawyer and client have copies in locations where the documents can easily be retrieved for future reference. Counsel hopes that they will be involved in subsequent amendments, but even if the client uses the same firm, different lawyers may handle the next lease amendment.

This all represents another reason to make sure any lease amendment is totally clear ("even clearer than it needs to be") and addresses all possible concerns. This way, the next person who reads the lease amendment, perhaps five years later, won't need to guess at what the parties really intended, or perform detective work to figure out what the lease amendment really means.