DRAFTING THE FLEXIBLE LEASE

ROFR – ROFO, Expansion Rights, Contraction Rights, Sublease
and Other Flexibility Clauses
In Commercial Leases

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I. INTRODUCTION

As the manner in which business have operated has changed over time, the commercial real estate industry has simultaneously adapted to those changes. Fortunes have been made and lost based upon the ability the owners of commercial real estate to understand these changes and adjust the use and development of real estate products to meet the changing needs of the business community.

One of the systemic changes over the past 30 years has been the transition of our economy to a serviced-based economy, rather than the production of goods. With this shift to the service-based economy, businesses have had to learn to both expand and contract, with great flexibility. This need for flexibility affects both small and large businesses alike. Smaller businesses must be able to manage their growth and may need to downsize quickly. Larger businesses must consider consolidation of divisions, relocations and reorganizations of departments that are constantly in motion as a part of their efforts to operate in a more efficient manner, as well as the impact of sales or acquisitions of components of the business operation.

The effect of this demand for flexibly has been greatly exacerbated by the impact technology is having on the way business is conducted. Not only has the increased role of technology modified the need for work spaces, but the demands of the workforce are also changing the nature and character of the work place.

One of the largest expenses a business may incur, after the cost of its employees, is the cost of its work place. Flexibility in scaling the cost of the work place has become increasingly important, especially for a company with unpredictable growth. Since it's not always easy to anticipate future business needs, tenants are increasingly focused on building greater flexibility into the terms of their commercial lease, often including the right to contract or expand their lease space, or otherwise modify their relationship with their landlord.

The purpose of this presentation is to highlight a number of the issues that may arise in a commercial lease negotiation as the tenant attempts to add flexibility to their lease.

II. OVERVIEW.

This presentation will highlight the following flexibility rights in commercial leases:

1. Short lease terms
2. Options to renew or extend the term;

3. Early termination rights;

4. Expansion rights by rights of first refusal or rights of first offer;

5. Assignments and subleases;

6. Increased workspace efficiency; and

7. Relocations rights

Each of the above flexibility rights are often viewed by landlords as a concession to the tenant. As such, it is not uncommon for the lease to provided that (i) these rights may only be exercised if the tenant is not in default of the lease at the time of the exercise, and (ii) the right may not be transferable to an assignee of the lease space.

As a part of exercising this these rights, in each case the landlord may require the tenant to reimburse the landlord for certain costs and expenses it may incur in the process of accommodating the tenant's exercise of the rights provided (including legal fees, engineering fees and other out of pocket costs). Additionally, the landlord will generally place certain restrictions or limitations on the exercise of the rights, so the landlord and tenant should be as precise as possible in defining these parameters.

Many leases will condition the exercise of these rights to a reasonableness standard. Given the somewhat unique nature of real estate assets and the circumstances surrounding the exercise of these rights, this may be a very difficult standard for a tenant to establish. For this reason a tenant may want to add some level of clarity to this condition to rely upon where the circumstances present themselves.

Where the exercise of the right is subject to the tenant not being in default of the lease, the parties should consider whether this prohibits a default before the expiration of any notice and right to cure periods that may be applicable to the infraction, or after? Sometimes this prohibition is drafted as limiting the right if the tenant has "ever been in default of the lease". This can be somewhat illusory as the tenant may have been in default at some time in the past and either the default was waived or cured, and therefore should not have an effect on the current status of the right to exercise the right.

Landlords often require the tenant to deliver the functional equivalent of an estoppel certificate in connection with the exercise of such a right, confirming that the lease is otherwise in full force and effect and that the landlord has fulfilled all of its responsibilities to the tenant through such date.

III. TERM.

A. Shorter Term with Options to Extend.

One method for building flexibility into a lease is to consider a shorter primary term and increased option rights to renew and extend the term of the lease. A shorter lease term (1-3 years) provides the tenant the ability to ensure that their business is going the way they want it to before committing to a longer term. On its face this approach provides the tenant greater flexibility, however, the shorter lease term may create issues for both the landlord and the tenant

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