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Leasing Institute

Issues in Drafting Expansion Rights and Contraction Rights in Commercial Leases

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1

What are Contraction Rights?

- Contraction rights are rights granted to the tenant or landlord for the purpose of reducing the amount of leased space by the tenant during the term of the lease.
- These rights are usually negotiated in the letter of intent process but sometimes arise during the lease term as the needs of landlord and tenant change.
- The common legal instrument for effectuating contraction rights are a partial surrender agreement, termination agreement or lease amendment.

2

Contraction Rights in the Context of Today's Market

- Before COVID-19, it was usually the goal of a tenant to negotiate with the mindset to obtain extension or expansion rights to increase the size or duration of their leases. However, COVID-19 has now since catalyzed the remote work dynamic that has shifted the interests of tenants and landlords.
- Tenants who were locked into large duration leases before COVID-19 have begun to emphasize need for reducing their square footage as many of the leased spaces are not being used.
- Many companies, especially in the tech industry have announced plans to shed all office spaces and permanently transition to full or partial remote workplaces.
- For example, Yelp Inc., is one of the companies who has downgraded their office presence, and their co-founder Jeremy Stoppelman defended this decision by stating that post-COVID-19 "Globally, about 1% of our workforce is choosing to come into the office every day."

Contraction Rights in the Context of Today's Market (continued)

- This shift in the leasing environment has called for a more tenant-friendly approach as Landlord's must be more flexible to the ever-changing environment.
- Tom Fulcher, chair of Savills Inc.'s legal group in an article in the American Lawyer stated: "[f]irms continue to sign 10-to-15-year leases, but longer-term leases didn't [use] to have termination options, and now they do" and "[t]here are also contraction options, which gives the right upon renewal to lease less space. That flexibility has become a huge part of deals."

Key Considerations Concerning Contraction Rights

- From a tenant's perspective, contraction rights provide the flexibility to changing business needs. Tenants who are currently negotiating long-term leases or pursuing a lease renewal should heavily consider pushing for these rights in the negotiation process.
- From a landlord's perspective, landlords should be flexible for tenant's needs, but also for its own needs. This means that if a landlord allows for a contraction right then landlords should consider negotiating a more substantial base rent amount, securing a landlord-friendly guaranty or an increased contraction fee. Further, landlord should consider whether if the surrendered space will be practical enough to re-lease to another tenant and if it will be profitable enough.

Issues in Drafting Contraction Rights

- Overall: The contraction option needs to be drafted with clarity and be detailed to as possible to eliminate ambiguity. Consider attaching the form of contraction instrument to the lease or lease amendment.
- Timeframe to exercise contraction right
 - The time frame to exercise the option should be specifically identified in the language. For example, commencing on the first day of the 60th lease month but before the last day of the 72nd lease month.
 - Is this a one-time option or does the party waive its right to exercise the contraction option if not exercised?
- Contraction date
 - For the contraction instrument, clearly identify the exact date in which the tenant will vacate the "surrendered premises."

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