

# A Look At Lease Expansion Options In A Challenging Market

By **Kris Ferranti** (January 26, 2023, 6:29 PM EST)

Expansion options in leases are a valuable tool for businesses looking to grow and adapt to changing circumstances.

These options provide tenants with the ability to rent additional space at a later date without committing upfront and can be particularly beneficial during economic downturns or times of economic uncertainty.

Economic uncertainty can make it difficult for businesses to predict future growth and make long-term commitments, making expansion options a useful solution to provide them with the flexibility to adjust to changing business needs.



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As landlords compete for tenants in a challenging market, offering expansion options can be a powerful incentive for businesses to sign long-term leases. However, as with any lease provision, it is important for both landlords and tenants to carefully consider the terms of an expansion option, as they can have a significant impact on the lease agreement.

By properly negotiating and drafting the terms of an expansion option, landlords can protect their interests and avoid costly pitfalls, while tenants can gain the flexibility to adjust to changing business needs without worrying about the expense of relocation.

## Negotiating Leverage

It is worth noting at the outset that tenants with significant leverage are more likely to be offered expansion options by landlords and are better positioned to bargain for more favorable terms.

There are several factors that can give tenants leverage in negotiating expansion options with landlords. The amount of space rented is an important factor, as tenants who rent a significant amount of space from a landlord may have more leverage in negotiations because they are bringing in more revenue for the landlord.

Creditworthiness is also a key factor, as tenants who have a strong credit history and financial stability may have more leverage in negotiations because they pose less of a financial risk to the landlord.

The length of the lease is another factor to consider, as tenants who have longer leases may have more leverage in negotiations because they are committing to a longer-term tenancy.

Finally, the landlord's need to fill vacant space can be a factor, as landlords who are struggling to fill vacant space may be more willing to offer expansion options to tenants in order to secure a long-term tenant. In general, leverage plays a significant role in determining the outcome of negotiations for expansion options, including whether the option is granted and the terms of the option.

## Types of Expansion Rights

There are three common forms of expansion options in leases: (1) pure expansion rights, (2) rights of first offer and (3) rights of first refusal.

A pure expansion right grants the tenant the right to expand into specific additional space when they choose to exercise the option, and the landlord is then obligated to make the space available and lease it to the tenant.

This is generally the least favorable structure for landlords because it encumbers the expansion space while the option is open. Rights of first offer require landlords to first offer newly available space to the tenant before advertising it on the open market.

Rights of first refusal allow the landlord to take the property to market and solicit bids for the space before making an offer to the tenant. However, if a third party has agreed to lease the space, the landlord must present the same deal to the tenant holding the right of first refusal, and the tenant must refuse the offer before the landlord can proceed with another deal.

Rights of first refusal can have a chilling effect on the market for the landlord's vacant space because potential tenants may be hesitant to negotiate an agreement that can be taken by a holder of a right of first refusal. Due to this effect, landlords are often resistant to offer this right and typically prefer to grant other types of expansion options.

### **Personal Right**

To reduce risk, landlords often include provisions in expansion options that restrict a tenant's ability to assign or transfer the rights to a third party.

Without such restrictions, the tenant could transfer the expansion rights to a party with a higher risk profile or who has significantly lower growth demands, potentially resulting in the expansion space falling into the hands of a less creditworthy party or remaining vacant and unable to generate revenue for the landlord.

To prevent this, landlords may include language stating that the expansion rights are specific and personal to the named tenant, meaning that only the named tenant can exercise or benefit from them.

However, a landlord may allow the tenant to assign or transfer the rights to designated parties, such as affiliates or successors following a merger or sale of assets. In some cases, landlords may also allow tenants with significant leverage to assign or transfer the rights to any transferee in connection with an assignment of the lease that is approved by the landlord.

### **Superior Stakeholders**

Landlords usually include clauses in expansion options that prioritize the rights of other parties over the tenant's rights in certain circumstances.

For example, if another tenant party has a prior claim to the expansion space, the tenant's rights will be subordinated to those of the other party. This helps landlords avoid granting overlapping rights to multiple parties, which can lead to legal disputes. Landlords may also prioritize the initial lease-up of the expansion space in order to prevent the tenant's expansion rights from forcing the space to sit idle for an extended period or harming the marketability of the space.

Additionally, landlords may include language that allows them to renew or extend existing tenants in the expansion space, even if the tenant does not have a renewal option in their lease, which takes precedence over the tenant's expansion rights.

### **Window Periods**

Landlords often include a window period to exercise in expansion options to specify the time frame in which a tenant must exercise their right to rent additional space.

This allows the landlord to plan for and control the encumbrances placed on their space by the option. Without this uncertainty, the landlord can predict when they may need to spend resources maintaining the space, prepare it for potential tenants, or take advantage of any gap before the

window period and between the end of the window period and the end of the lease.

Landlords usually want the window period to be as short as possible, commencing after the tenant receives notice of the landlord's anticipated delivery date for the expansion space.

However, tenants with significant leverage may seek longer or multiple window periods over the course of the lease.

In addition, landlords often include language suspending the tenant's expansion rights for a certain period before the end of the lease. This is usually 2 to 5 years before the end of the term, depending on the length of the lease.

However, landlords may allow the tenant to exercise their option within this period if they agree to a renewal or extension of the lease, requiring the expansion space to be included in the renewal term as well.

### **Delayed Delivery Date**

When a tenant exercises its expansion option, landlords often want the flexibility to deliver the additional space over a period of time.

To allow for this, landlords may include a delayed delivery date in the expansion option. The delivery date will depend on the type of expansion option being used.

For options that grant a pure expansion right, an outside delivery date is often set in the lease. For options that use a right of first offer, the delivery date is typically determined by the delivery date specified in the right of first offer notice the landlord delivered to the tenant.

And for options that use a right of first refusal, the delivery date is usually based on the date that the third-party bidder had agreed to in the competing offer. A delayed delivery date gives landlords more control over the timing of the expansion and allows for necessary preparations or renovations. It also gives landlords the opportunity to fill any remaining vacant space before the expansion takes place.

However, it is important for the parties to carefully consider the length of the delivery period and ensure that it is reasonable given the circumstances.

### **Minimum and Maximum Space Requirements**

Landlords often require tenants to rent a minimum and maximum amount of additional space when the option is exercised. By imposing these requirements, landlords can optimize the use of space in a building and avoid having to divide or reconfigure the premises in an undesirable or inefficient way. It can also give landlords with multiple grants of expansion rights the flexibility to mitigate the risks of overlapping grants and confusing spatial configurations.

In most cases, this requirement means the tenant must take the remaining space on a floor or expand into adjacent space. However, it could also mean the tenant must take an entire floor or whatever is being offered, even if they only need part of it.

### **Minimum Occupancy Requirements**

Landlords often also include a requirement that the tenant must occupy a minimum amount of already-leased space at the time the option is exercised. This requirement is meant to prevent the tenant from using the expansion option for purposes other than obtaining additional space. Landlords are usually concerned with preventing the tenant from becoming a rival for the landlord's vacant space or from unfairly profiting through the assignment or subletting of the expansion space.

In order to define "occupy" in a way that meets the needs of both parties and avoids internal competition, landlords and tenants should work together to determine a suitable definition. As long as the tenant's rental obligations are being met and internal competition is avoided, landlords typically allow tenants some flexibility in defining "occupy" for the purposes of this requirement.

## **Lease in Effect and No-Defaults Requirements**

When a commercial tenant exercises an expansion option, lease-in-effect and no-default requirements may be included in the lease.

These provisions ensure that the tenant is not in default of the lease and that the lease is in full effect at the time of the expansion. This is intended to protect the landlord from the risk of both the originally leased space and the expansion space being tied up if the tenant becomes financially distressed.

While the landlord is still at risk for the tenant becoming financially distressed under the original lease, this risk is typically contained to the originally rented space until the expansion option is exercised. By requiring that the tenant is free of defaults at the time the option is exercised, landlords can prevent such risks from affecting the expansion space.

However, it is often negotiable between the parties whether these restrictions apply to past defaults during the lease term, judgments of default after judicial process or the mere state of being in breach of an obligation under the lease and defaults at the time notice of expansion premises' delivery is given or only those existing at the time of its commencement.

## **Conclusion and Summary**

In summary, expansion options are agreements that allow tenants to rent additional space beyond what they originally leased at some point in the future.

These options can take the form of a pure expansion right, which guarantees the tenant the right to expand into a designated space once exercised; a right of first offer, which requires the landlord to offer the space to the tenant before advertising it to the public; or a right of first refusal, which requires the landlord to offer the space to the tenant after receiving a bid from a third party.

Expansion options can be beneficial for landlords trying to fill vacant space and attract long-term tenants, and for tenants seeking spatial flexibility and the ability to accommodate future growth. However, negotiating expansion options can be complex, and landlords are cautious when offering them.

To reduce risk, landlords may include certain conditions in the options to protect their interests, such as requirements around the structure of the option, the window period for exercising the option, the amount of space required to be rented upon exercise, the minimum amount of space required to be occupied before exercise, the delivery date of the expansion space, consideration of the rights of superior stakeholders, and the requirement that the tenant has no defaults and the lease be in full effect at the time of exercise.

These conditions are usually negotiated and tailored to the specific circumstances and leverage of the landlord and tenant.

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