

"I Am Negotiating a Lease That Will Contain an Option to Extend. Should Rent During the Option Period Be Set by Appraisal?"

In short-term leases (five years or less), rent escalators are often based on a formula. The escalator might be a fixed annual percentage increase, or, during inflationary times, the consumer price index. When the original term plus option terms total less than ten or twelve years, it is common for the same escalator used in the original term to continue into the option term. If the escalator produces a higher-than-market rent during the extended term, the tenant is protected because it can elect not to exercise the option and simply move out. In practice, this often leads to a negotiated reduction in the option term rent from the rent that the escalator would have produced.

Formula escalators are nice because they are objective and certain. With longer-term leases, however, the chances increase that the rent escalator will produce a rent that is out of whack with the market. Neither landlords nor tenants can predict what market rent will be ten, fifteen or twenty years into the future. For this reason, landlords and tenants often include an appraisal mechanism to reset the option term rent to "fair market rent." The beauty of such a mechanism is that it usually causes landlords and tenants to sit down and negotiate a fair rent for the option term. This is because landlords and tenants hate paying their appraisers, almost as much as they hate paying their lawyers.

On the off-chance that the appraisal mechanism might actually be used someday, here are some features that should be built into the machinery:

- State minimum qualifications for the appraiser (for example, "an MAI appraiser who has at least ten years' experience in appraising commercial real estate in south central Wisconsin")
- If each party is supposed to designate an appraiser, state what happens if one of the parties fails to do so
- If you are the landlord, provide a floor for the rent during the extended term (for example, "in no case shall rent for the extended term be less than the rent payable during the last year of the original term")

POSTED:

May 18, 2008

RELATED PRACTICES:

[Real Estate](#)

<https://www.reinhartlaw.com/practices/real-estate>

RELATED PEOPLE:

[Jesse S. Ishikawa](#)

<https://www.reinhartlaw.com/people/jesse-ishikawa>



- If you are the tenant, give yourself the right to back out if the appraisal produces a rent that is too high for your taste
- Make sure the timing works. If the appraisal process is going to take three or four months, and the tenant has the right to back out after the appraisal is complete, there should be enough time left so that the tenant has enough time to find a new place, and the landlord has enough time to find a replacement tenant

These materials provide general information which does not constitute legal or tax advice and should not be relied upon as such. Particular facts or future developments in the law may affect the topic(s) addressed within these materials. Always consult with a lawyer about your particular circumstances before acting on any information presented in these materials because it may not be applicable to you or your situation. Providing these materials to you does not create an attorney/client relationship. You should not provide confidential information to us until Reinhart agrees to represent you.