Lease Extension Options, Baseball Arbitration and Forfeiting the Ball Game

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I wanted to report on a fairly recent unpublished opinion by the California Court of Appeals - Zawtocki vs. Black Angus Steakhouses, LLC, E062969 (Cal. Ct. App. Aug. 11, 2016). The Zawtocki case dealt with a tenant's exercise of an option to extend its lease and it demonstrates what can go wrong when the landlord fails to comply with the terms of the lease. But before I discuss the Zawtocki case, I would like to make a few general points about lease extension options.

Those of us that are in the business of representing tenants and landlords in commercial lease transactions know that: (1) every sophisticated tenant wants one or more options to renew or extend the term of their lease; and (2) every sophisticated landlord would prefer not to grant any renewal or extension options at all. By the way, there is a difference between an option to renew a lease and an option to extend a lease - but that's a topic for another day. For convenience, I'll refer to options to renew and options to extend as "**extension options**," the portion of the lease term that is covered by the extension option will be referred to as the "**extension term**" and the portion of the lease term that precedes the extension term will be referred to as the "**primary term**."

Extension options generally come in one of two flavors: (1) fixed rate extension options; and (2) fair market rent extension options. A fixed rate extension option is one where the landlord and tenant set forth the extension term rental rate at the outset (i.e. when the lease is executed and before the extension option is exercised). Given the challenge of trying to predict future rents, a landlord that provides a forward rent commitment only does so when it believes that it must in order to get the tenant to commit to the primary term and/or the landlord is fairly confident the future rental rate is likely to provide a favorable return. A fair market rent extension option is one where the landlord and tenant agree that they will determine the extension term rental rate at a future date that is appropriately close to the commencement of the extension option and (more often than not) only after the extension option is exercised.

The negotiation and implementation of a fixed rate extension option is fairly mundane - except, of course, when the tenant calls your office asking what to do when they suddenly realize that they failed to exercise the extension option in a timely manner or otherwise failed to satisfy the conditions applicable to the exercise of the extension option. That's when things can get really interesting. But that too is a topic for another day.

The negotiations relating to a fair market rent extension option are more arduous and often focus on, among other issues: (1) whether the fair market rent is determined before or after the tenant exercises the extension option (and if after, whether the tenant is permitted to annul the exercise of

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the extension option if the fair market rent is found to be more than what the tenant considers to be acceptable); (2) whether the extension term rent is 100% of fair market rent or, given the inherent savings to the landlord in not having to re-lease the premises to a new tenant, something less than full fair market rent (e.g. 90%-95% of fair market rent); (3) the scope or boundaries of the "market"; and (4) the mechanics of discovering the fair market rent.

The mechanics for discovering the fair market rent vary, but they often involve an initial period where the parties attempt to determine the fair market rent through negotiation, failing which the parties will then embark on a more formal process that involves one or more qualified appraisers that will determine the fair market rent and impose the solution on the parties.

Considering that most leases require that the tenant exercise the extension option *before* the fair market rent is determined and do *not* allow the tenant to annul an improvidently exercised extension option, it is not surprising that most tenants that have fair market rent extension options do not exercise them because of the uncertainty that they pose. Instead, tenants attempt to negotiate an extension term outside the four corners of the fair market rent extension option.

So what happened in the Zawtocki case and what can be learned from it? In Zawtocki, the landlord and tenant had entered into a ground lease that had a 20-year primary term and afforded the tenant three consecutive options to extend the lease term for 5-years per extension option. The lease provided that if the tenant exercised the first extension option, then the rent would be determined by the following process: (1) landlord was required to inform the tenant of the landlord's opinion of fair market rent for the leased premises within thirty days after the tenant exercised the extension option; (2) the tenant would be bound by the landlord's opinion of fair market rent unless the tenant informed the landlord of tenant's opinion of fair market rent within thirty days after it received the landlord's opinion; (3) if the parties were unable to resolve their differences within ten days after the tenant tendered its opinion of fair market rent, then the parties would be bound by the tenant's opinion unless the landlord demanded binding arbitration within fifteen days after the tenant tended its opinion; and (4) if the landlord demanded arbitration, then the arbitrator would have to adopt either the landlord's opinion or the tenant's opinion (i.e. so-called "Baseball Arbitration" - the arbitrator was *not* permitted to set the fair market rent at something above the landlord's opinion, below the tenant's opinion or between the two opinions). If the tenant exercised the second extension option, the rent would be 110% of the rent during the first extension term and if the tenant exercised the third extension option, the rent would be 110% of the rent during the second extension term. The lease also included a definition of "fair market rent," which was to be based on eight specific factors.

In Zawtocki, the tenant exercised the first extension option and shortly thereafter, the landlord hired an appraiser to inform the landlord of the fair market rent. After the landlord received the appraisal, the landlord informed the tenant that it considered the fair market rent to be $X per year. Seven days later, the tenant informed the landlord that it considered the fair market rent to be $X-$Y per year. However, the tenant's opinion of fair market rent was not informed by a real estate appraisal. Instead, the tenant merely applied the same annual percentage increase in rent that had applied during the primary term, to the first extension term. The landlord acknowledged receipt of the tenant's opinion four days after receiving it, but the landlord rejected the tenant's opinion because the landlord believed that it was too low and untethered to the fair market rent definition set forth in the lease. Rather than demand arbitration, the landlord merely re-asserted its original fair market rent opinion and waited for the tenant to respond. Seventeen days after the landlord received the tenant's

opinion, the landlord emailed the tenant to inquire whether it had received the landlord's prior correspondence re-instating the landlord's fair market rent opinion. The tenant's attorney responded to the landlord two days later (i.e. on the nineteenth day after the tenant furnished its fair market rent opinion) and the tenant's response merely directed the landlord to the applicable section of the lease that stated that the tenant's fair market rent opinion prevailed over the landlord's opinion because the landlord had failed to demand arbitration within fifteen days after the tenant tended its opinion. Two days later, the landlord finally got around to hiring a lawyer who sent a demand for arbitration to the tenant's attorney. But the tenant refused to proceed with the arbitration.

With seven figures of foregone rent on the line and a tenant that was unwilling to compromise given the then current state of affairs, the landlord's attorney filed a lawsuit seeking to compel arbitration to determine the fair market rent in accordance with the lease. In opposing the landlord's lawsuit, the tenant cited Platt Pacific, Inc. v. Andelson, 6 Cal.4th 307 (1993), which held that the failure to make a timely demand for arbitration results in forfeiture of the right to compel arbitration. In other words, the landlord didn't strikeout, the landlord forfeited the ball game because it never showed up to play ball. The trial court agreed that Platt Pacific was controlling, the trial court saw no equitable grounds for saving the landlord after its unforced error and, therefore, denied the landlord's petition and awarded the tenant its legal fees. The landlord then appealed the trial court's decision and the appellate court affirmed and awarded the tenant its legal fees on the appeal.

The decision in Zawtocki was a great result for the tenant and an awful result for the landlord. But the outcome could easily have been different. The tenant's opinion of fair market rent prevailed because the landlord failed to comply with the lease. Had the landlord made a timely demand for arbitration, the costly litigation would have been avoided and the landlord may have been in a superior position, if not to win the arbitration (remember landlord's opinion was supported by an appraisal while the tenant's was not), at least to create the leverage and additional space needed to negotiate a settlement. The Zawtocki case serves as a cautionary reminder to both landlords and tenants that they need to thoroughly understand how the extension option operates well in advance of the date the option is exercised and plan accordingly.