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The vagaries of purchase option clauses in leases

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Over the years I have had cause to be involved in numerous valuation assignments in which tenants were attempting to exercise purchase options that had been included as part of the language of an original lease. What I have found in many cases is that the terms of the purchase option clause may be interpreted differently by two competing appraisers involved in the process because of the exclusion of one or two descriptive terms. The result may be that the appraisal process becomes one that was not intended by the original participants in the agreement and which ultimately favors one of the parties in the transaction over another. The following two examples are provided of issues that may be vague in a lease/purchase option agreement and how such language might be interpreted.

Example 1: A tenant with a below/above market lease that runs from 2000 to 2015 has an option to purchase at any time subsequent to 2008 at fair market value. The critical issue here is whether or not the estimate of fair market value is intended to consider the effects of the contract rent or not.

If a property is leased at a rental rate that is above market it would behoove the tenant to value the property based upon market rent whereas the lessor would want to value the property subject to the above market contract rent. While the owner's position is understandable, as he would be giving up the benefit of above market cash flows in the event of a sale, the real question is what was the intent of the respective parties when the lease was signed. Was it to provide a protection to the tenant in the event the market changed or was it for the landlord to be made whole in any situation.

The converse situation applies when a lease rate is below market. Now it is in the lessor's best interest to argue that the purchase option price should be based on market rents while the tenant will argue for a valuation based on contract rents. In either event, the way to clarify this issue up front is to state that the fair market value estimate should be made either subject to, or exclusive of, the contract terms of the lease.

Example 2: A tenant occupying a more unique asset with a lease until 2010 has a purchase option at the end of the lease term at fair market value. The critical issue here may be one of the effects of occupancy.

An example is a large 150,000 s/f manufacturing plant that may have been built in 1995 by a landlord at a cost of $7.5 million. Sales data for fairly modern buildings may cover a wide spectrum of prices with transfers of former owner occupied properties that sell vacant being priced at $25 to $30 per s/f and transfers of long term leased properties that are physically similar in age, size and condition to the vacant asset being priced at $60 per s/f and higher. The question then is which type of sale is relevant to the assignment. Language in the purchase option clause defining that the value is to be based on comparable buildings that are either fully occupied or vacant would reduce the disparity in valuations that often exists given this set of circumstances.

Overall, I have found that typically the parties involved in the original agreement may not be around when it is time for a purchase option to be exercised and any confusion regarding language tends to set the starting point for disparate valuations and extensive litigation. While the aforementioned examples are not the only issues that can cause disparity they are among the more common and should be clarified when possible.

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