

New York Law Journal

Real Estate Trends

WWW.NYLJ.COM

VOLUME 262—NO. 118

An **ALM** Publication

WEDNESDAY, DECEMBER 18, 2019

TRANSACTIONAL REAL ESTATE

Considerations For Ground Rent Reset Provisions



By
**Peter E.
Fisch**



And
**Mitchell L.
Berg**

Due to the long-term nature of ground leases, the rent that was initially negotiated between the parties may lag behind market ground rents after a period of time, even with fixed or consumer price index (CPI)-based increases. As a result, ground lessors often insist on rent reset clauses on a periodic basis so that the ground rent captures some of the increase in land values. While there are many variations, a “typical” rent reset clause provides that at predetermined times during the term of the lease (e.g., every 20 or 25 years), the rent will be increased to an amount equal to a percentage (typically 5-6%) of the then fair market value of the land (usually determined as if free and clear of liens and encumbrances, including the lease, and vacant and exclusive of the improvements). The purpose behind rent reset clauses is simple—to capture any change in the fair market value (and fair market rental value) of the leased property. However, the application of rent reset clauses in practice is anything but simple, and

the consequences of such clauses can be significant.

While landlords favor rent reset clauses because they believe fixed percentage or CPI adjustments rarely keep pace with increases in the value of real property over the long run, tenants and their lenders¹ are increasingly objecting to typical rent reset clauses in ground leases because of the risk and uncertainty that they can pose. While the parties would ideally negotiate to reach settlement on the fair market value of the leased property, and therefore, the new rent, this often does not happen in practice. When the parties are unable to agree on the new rent, an arbitration or litigation usually ensues and the parties become subject to the unpredictability of a third-party decision. The consequences of a rent reset can be dire, resulting in the tenant not being able to finance its interest in the property² or even losing its lease.³

Interpretation and Implementation

One set of complications in the application of typical ground rent reset clauses relates to the interpretation of such clauses. Some considerations may not have been addressed in the lease provisions while others, even though addressed, may not have

been thought through or are otherwise unclear, leading to disputes between the parties.

For example, the parties are not always explicit as to just what is being valued. Is it just the land, or the land with the improvements that the tenant

The purpose behind rent reset clauses is simple—to capture any change in the fair market value (and fair market rental value) of the leased property. However, the application of rent reset clauses in practice is anything but simple, and the consequences of such clauses can be significant.

constructs on the land? If it is just the land, should it be valued vacant and unencumbered, as if the lease did not exist, or should the lease be somehow taken into account? If the lease makes clear that the leased property is to be valued unencumbered by the lease, then an appraiser will likely value the land assuming it will be used for its unrestricted “highest and best use,” which can result in a large increase in the rent payable for the rent reset period at issue since the highest and

PETER E. FISCH and MITCHELL L. BERG are partners at Paul, Weiss, Rifkind, Wharton & Garrison. STEVEN SIMKIN, of counsel, ALLEN M. WIEDER, counsel, and RUOBING CHEN, associate, assisted in the preparation of this article.

best use is not always consistent with what has actually been constructed on the land and the use and other restrictions in the lease. However, note that unless the parties have explicitly provided that the land is to be valued unencumbered by the lease (or words of similar effect), a court will likely determine that the land is to be valued as encumbered by the lease.⁴ This is evident in several New York court rulings, including in *United Equities v. Mardordic Realty*,⁵ *936 Second Avenue L.P. v. Second Corporate Development Co., Inc.*,⁶ and *Plaza Hotel Associates v. Wellington Associates, Inc.*⁷

If the parties decide that the fair market value of the leased property is to be determined as encumbered by the lease (or do not provide for the contrary), the parties should also carefully consider what terms of the lease should matter for purposes of valuing the property. For example, should only the use provisions of the ground lease matter, or should the remaining term of the ground lease (including rights to extend or renew), purchase options, preemptive rights (such as rights of first refusal) and other restrictions or requirements (e.g., that the improvements cannot exceed a certain size) in the ground lease also be taken into account?

Beyond the considerations described above, there are additional issues that may not have been considered during the lease negotiations and may only be brought to light when the rent reset period is imminent. Some examples are:

Assemblage Value: If the leased property is a part of an assemblage or combined zoning lot, should the fair market value of the leased property include the value of any additional development rights that the site is then entitled to use? On the one hand, without the leased property, the tenant would not have

been able to obtain the additional development rights and increase the size of its development. On the other hand, the tenant may have paid for the additional development rights and done the leg work in creating the assemblage.

Construction Issues: Should construction issues due to site limitations (e.g., difficulty due to limited street space for trucks, etc.) be taken into account? On the one hand, construction issues can to some extent be managed by the tenant in its construction staging and development plans, and may even be caused by the tenant. On the other hand, site limitations can be fundamentally tied to the land itself.

Timing of Valuation: Instead of setting the valuation date as the rent reset date, should there be multiple valuation dates to account for the possibility of the rent reset date falling in the middle of a real estate recession or boom? Choosing a single valuation date can result in a rent that is drastically different from the one that was previously being paid, and the results of such valuation have long term consequences as the next rent reset period may not be for another 20 or more years.

Tax Abatements: Should tax abatements, which would make a property more valuable while the abatement is in effect, be taken into account in determining the fair market value of the leased property? On the one hand, the landlord may have cooperated with the tenant in obtaining the tax abatement and, but for the landlord's cooperation, the tenant would not have been able to obtain such tax benefit. On the other hand, the tenant may have been the one to apply for, and do all the work necessary to obtain, the tax abatement. The tenant

may also have realized reduced cash flow (for example, by agreeing to an affordable housing requirement) in order to obtain the tax abatement.

Regulatory Requirements: Should the fair market value be subject to regulatory requirements (such as rent stabilization and rent control laws, landmark regulations, etc.), which can reduce the fair market value of the leased property? On the one hand, regulatory requirements are often tied to what is ultimately built on the leased land, in which case they should not affect the value of such land if it is to be valued vacant and unimproved. On the other hand, not taking into account the regulatory requirements may be viewed as unrealistic and punitive to the tenant since what has been built will continue to be subject to such regulatory requirements.

Zoning Changes: Should a change in zoning (whether it is an upzoning or a downzoning) affect the fair market value of the leased property? Should it make a difference if the tenant can or cannot alter its development or building to take advantage of an upzoning? Conversely, if a building is a legal nonconforming use, should the fair market value of the land be reduced because of a downzoning? On the one hand, zoning regulations are an integral factor in determining the value of a piece of land. On the other hand, what the tenant has built will most likely not be affected by a change in zoning.

Another set of complications that arise in the application of typical ground rent reset clauses relates to how (or the process through which) the fair market value is ultimately determined. Assuming the parties do not initially agree on a fair market value, the parties will undoubtedly

obtain appraisals of the property, with the appraisers making their own interpretations of what the lease requires to be valued and, based on their reading of the lease, what factors to take into account in performing their valuations. This means that appraisals are always subjective. Appraisals can become even more subjective if, for example, the parties are in a down market when there may not be any recent transactions of similar properties to use as comparables (or “comps”). The less similar or less recent a comp, the more complicated and subjective the adjustments to the comp become, giving the parties more to argue over.

How “well” an appraisal is done (and, therefore, how defensible it is) comes into play during what is presumably the next step in the process—an arbitration or litigation proceeding. A lease might provide for an arbitration proceeding where one or more arbitrators (usually appraisers themselves) will decide on a final and binding “fair market value” (whether it is the appraised value proffered by one or the other of the parties, an average of the parties’ appraised values, the arbitrators’ own determination or a value determined on the basis of some other formula). If the lease does not provide for arbitration, or if there are legal issues that the parties want resolved before going into or during the arbitration process, then a court may get involved. All of this is to say that these processes take time, can become very costly and cannot ensure that the outcome is a “fair” one that the parties can live with.

Considerations Going Forward

One way to avoid the complications and uncertainty in ground rent resets is to eliminate the concept altogether and have the rent escalate annually pursuant to a fixed percentage or CPI

increase. While, as mentioned above, landlords do not believe that such an adjustment adequately takes into account increases in the value of real property, long-term studies that have compared CPI data to real estate values have actually found that there has been very little appreciation in real estate values beyond inflation and that real estate is an asset whose value does

One way to avoid the complications and uncertainty in ground rent resets is to eliminate the concept altogether and have the rent escalate annually pursuant to a fixed percentage or CPI increase.

little more than keep pace with inflation over the long run.⁸

If the parties are not willing to eliminate a ground rent reset provision altogether, they can always try to lessen the ambiguity and uncertainty of an appraisal, arbitration and/or litigation process by identifying and considering, during lease negotiations, as many factors as possible that can affect the value of the leased property and decide whether or not such factors should be taken into account in determining the “fair market value.” While not all factors can be anticipated and reflected in the ground lease (e.g., the availability of comps in a down market), if the parties can agree on what should be valued and what factors should be taken into account in arriving at such a value, and have the lease drafted to reflect such agreement as clearly as possible, the parties can reduce the number and magnitude of subjective factors that go into the determination of the appraised values that would otherwise be in the appraisers’ discretion. (The parties can, and should, consult an appraiser in the drafting of the rent reset and appraisal

provisions to get a sense of how they would interpret such provisions.) Ultimately, this should lead to the parties’ respective appraised values being closer, which would, in turn, result in a higher likelihood that the parties will be able to settle on the new rent without the need for an expensive arbitration or litigation process.

.....●●●.....

1. If there is an unanticipated increase in ground rent payments, the revenues from the property may not be able to support the ground rent payments or both the ground rent payments and the mortgage payments. This can cause the ground tenant to default under the ground lease and/or the leasehold mortgage.

2. A recently publicized example of this was the difficulty that RFR Realty had in securing a refinancing of its mortgage loan for 390 Park Avenue (commonly known as the Lever House) due to the fact that the ground lease was coming up for a renewal in 2023, at which time the annual rent would be reset and increase from \$6 million to \$23 million. Lois Weiss, Park Avenue’s Lever House CMBS loan lost \$68.3M: report, NEW YORK POST (February 19, 2019 10:27pm), <https://nypost.com/2019/02/19/park-avenues-lever-house-cmbs-loan-lost-68-3m-report/>.

3. Although not a ground lease, a recent example of this is the Barneys New York rent reset, which, after an arbitration proceeding, resulted in Barneys having to pay a new rent of almost double its prior rent. Barneys has since filed for bankruptcy and will be closing its retail stores. Lisa Fickenscher, Rising rent at Barneys’ flagship store led to Chapter 11 filing, NEW YORK POST (April 6, 2019 10:21pm), <https://nypost.com/2019/08/06/rising-rent-at-barneys-flagship-store-led-to-chapter-11-filing/>.

4. See Tony Sevelka, Ground Leases: Rent Reset Valuation Issues, THE APPRAISAL JOURNAL, Fall 2011, at 320 (stating that courts have consistently held that the lease itself is an encumbrance that must be taken into account in fixing the rent unless there is explicit language that the lease should be disregarded).

5. 8 A.D.2d 398 (N.Y. App. Div. 1959).

6. 10 N.Y. 3d 628 (2008).

7. 55 Misc.2d 483 (Sup. Ct. N.Y. Cnty.), aff’d 28 A.D.2d 1209 (1st Dept. 1967), 22 N.Y.2d 846 (1968).

8. William C. Wheaton, Mark S. Baranski & Cesarina A. Templeton, 100 Years of Commercial Real Estate Prices in Manhattan, REAL ESTATE ECONOMICS, September 2009, at 70, 79. See also Joshua Stein, The Most Important Issue in Every Ground Lease, N.Y. REAL PROPERTY LAW JOURNAL, Winter 2014, at 23 n. 5.