Chapter 2

Base Rent and Other Payments

§ 2:1 Ground Lease Rental Rates
  § 2:1.1 General Considerations
  § 2:1.2 Structural Objectives
  § 2:1.3 Market Factors in Ground Rent
  § 2:1.4 Lease Terms Affecting Ground Rent

§ 2:2 Preconstruction Period
  § 2:2.1 The “Option Period”
  § 2:2.2 Rental Considerations
    [A] Tenant Costs
    [B] Landlord Costs
    [C] Work Product; Minimum Expenditures
    [D] Length of Option Period

§ 2:3 Construction Period Rent

§ 2:4 Minimum Rent
  § 2:4.1 Landlord’s Commitment
  § 2:4.2 Inflation Indexes
  § 2:4.3 Other Inflation Adjustments
  § 2:4.4 Step Rents

§ 2:5 Appraisal Methods
  § 2:5.1 Relation to Length of Term
  § 2:5.2 No Change in Use
  § 2:5.3 Value Based on Existing Improvements
  § 2:5.4 Residual Land Value and Use Value Assessment

§ 2:6 Renewal Rent
  § 2:6.1 Legal Issues
  § 2:6.2 Basis of Renewal Rent

§ 2:7 Minimum Rent Adjustments
  § 2:7.1 Lender Priority
  § 2:7.2 Occupancy Tenant Pass-Throughs

§ 2:8 Taxes and Other Payments
  § 2:8.1 Deferred Taxes
  § 2:8.2 Assessments

(Whalen, Rel. #4, 8/15) 2–1
§ 2:1  Ground Lease Rental Rates

§ 2:1.1  General Considerations

The ground lease rent may be determined in two very different contexts. In the initial negotiations, the principals have very often agreed on a base rent before the letter of intent stage, when most of the other terms of the ground lease are still to be determined. Later, long-term ground leases often provide for a redetermination of the base rent to protect the landowner against inflation and other economic changes, by arbitration or the like, in which the other terms of the ground lease are set and cannot be changed by the appraisers or arbitrators.

In each of these contexts, the following general characteristics of ground rentals need to be kept in mind. First, it is usually feasible to establish a fair market value for the land, primarily from actual transactions in the same market area. But very often, outside of a few limited areas [such as Manhattan or Honolulu], there may be few if any recent actual lease transactions to establish ground lease rates of return. Sometimes, the lease will specify, in the event of a reappraisal, that the rent shall be a fixed percentage of the appraised land value, for instance, 7% or 8% of the land’s FMV. Sometimes the rate of return is tied to a market rate, for instance, the ten-year Treasury rate plus 4%, or the AAA bond rate. Often the rate of return and the land value must both be determined by the appraisers or arbitrators.

This invokes the second general characteristic of ground lease rents: that absent “subordination of the fee,” the landlord’s position in a ground lease is as much like a financial instrument as a real estate

2. See supra section 1:8.
3. See infra section 2:5.
4. See supra section 1:3.
5. Carneghi, supra note 1, at 256.
6. This may be a good idea if the parties want to eliminate a degree of uncertainty from the reappraisal process. See discussion infra section 2:5.
7. See infra section 2:5.
8. See infra chapter 5.
investment. The landlord generally does not have any management or operating risks or responsibilities or any investment in improvements subject to physical depreciation. Yet even with an unsubordinated ground lease, the landlord faces a degree of unavoidable risk: preconstruction delays and possible termination; construction problems, including lien claims; poor markets for the project that might lead to tenant default and/or bankruptcy. Carneghi suggests that ground lease rates need to reflect a degree of real estate risk and should be something greater than AA bond rates. But this can be misleading at times when interest rates are historically low or high due to economic conditions, which may be periods when few if any ground leases are being entered but may well be a time when some ground lease rents are up for reappraisal. In some respects, a landlord’s position under a ground lease is a unique investment; it is not like owning an operating property; as noted above, the landlord usually does not have any operating responsibilities, but the attendant risks are at least qualitatively different from those of corporate bonds or most other financial instruments. Usually there is no real market, such as those for financial instruments, to refer to in order to establish any going rate. Fixing ground lease rental rates is much more an art than a science.

§ 2:1.2 Structural Objectives

No landowner today should be willing to sign a long-term ground lease with a fixed annual rent for the entire term. The landowner wants periodic adjustments to reflect inflation and changes in the value of the land. Developers and their sources of financing will resist any adjustments that are not limited in amount and calculable in advance. Where the project is financed with a leasehold mortgage loan, the ground rent is senior to debt service and must be paid even by the lender following foreclosure, a sort of “super senior” obligation secured by both the tenant’s equity and the lender’s advances. Even if the fee is “subordinated,” the tenant is still concerned that the ground rent is affordable and appropriate for the project and the lender still does not want to fund a project that might face financial difficulties. The tenant is entitled to protection from rent increases

10. See infra section 8:2.
11. See infra sections 10:3 and 10:4.
12. Carneghi, supra note 1, at 263.
13. In which case the lender, after foreclosure, would take free of the lease and the obligation to pay ground rent.
14. Ground rent as a function of total costs is usually not an enormous expense, maybe something of the same order of magnitude as property
that do not reflect the project value (or, at least, the value of the
land as a component of the project that the parties contemplated).
Similarly, the landlord, who has committed her land to the tenant’s
project for a number of years, is entitled to some assurance that the
ground rent will not become insignificant due to inflation. The
leasehold lender needs to know how much ground rent must be paid
before cash flow from the project can be used to pay debt service.

In the context of project financing, the ground rent structure
primarily affects the leasehold lender’s appraisal (that is, valuation)
of the project as collateral for the loan. Since the rent must be paid
prior to debt service, it is a deduction in determining the cash flow
from the project for the lender’s appraisal. Project value for the lender
is generally the capitalized value of free cash flow. So, in effect, some
multiple of the ground rent will be a deduction from the lender’s
appraised value. The degree of sensitivity in project financing to
these concerns will vary depending on such factors as the size of the
project, the amount of equity invested, the credit of the borrowers, and
the extent of preleasing. Financing for smaller projects with good
credit may not be particularly sensitive to the ground rent. Smaller
projects tend to be credit-sensitive; larger projects tend to be appraisal-
sensitive.

The sophisticated ground lease should provide to the landowner a
return over time reflecting increases in the value of the property, as a
component of the project that the parties expect to be built and
maintained on the land (including any improvements or redevelop-
ment that might be made after initial development). Three methods
are frequently used to achieve these results, often in combination:

15. Sometimes the argument is heard that ground rent should not increase due
to the additional value created by the tenant’s investment and efforts; that
rent should only increase if land value increases independent of the
tenant’s project. Ironically, this is a poor argument for the tenant; rather,
this is exactly what the tenant wants to avoid. If land value increases due
to changes in the neighborhood or zoning changes or general inflation in
land prices, increases in ground rent may threaten the project’s financial
viability unless the ability of the project to generate cash flow also
• base rent increases keyed to inflation indexes;
• periodic reappraisals of land value; and
• percentage rentals.

The last of these is considered at length in the next chapter. Particularly with smaller projects, the parties usually want to avoid the complexities of percentage rent calculations. However, it is one argument of these two chapters that a well-constructed percentage rent clause may best serve the interests of the landlord, the tenant/developer and the lenders in the long run and alleviate many of the concerns created by various other methods of adjusting rents.

§ 2:1.3 Market Factors in Ground Rent

The basic issue in the valuation of any asset is market demand. Where demand is high, there may even be competition for property offered for lease. Where demand is low, due to general economic conditions or the location or zoning of the property or other factors, there will usually be no ground lease. Most developers avoid ground leases if they can due to their complexity and transaction costs and the difficulty and expense of financing.16 When ground leases occur, rental rates may be influenced by a number of “external” market factors:

Property Characteristics. Of course, the location, zoning, topography, permitted uses, and allowed density will all affect land value and rates of return. Smaller sites with higher density (like a downtown office building site) will generally be more valuable than larger, less dense sites (like suburban retail or low-rise office), depending on market demand. Higher values will prevail when both the available land is limited and demand is high (and ground leases are typically undertaken where land is limited and when demand is high). Often, the initial ground rent agreed to will require the tenant to obtain favorable permitting determinations from the authorities, which will be a condition to proceeding with the lease. Later, when the rent is up for reconsideration, these market factors may vary considerably from conditions prevailing when the lease is originally entered.

The physical condition of the property may significantly affect its value. A lower initial base rent may reflect anticipated additional development costs related to the property: removal of existing improvements or termination of existing tenancies; remediation of increases. For financing purposes, what the tenant really needs is ground rent indexed directly to the capacity of the project to generate cash flow. This is one argument, from the tenant’s perspective, for a rent structure with a modest base rent and a meaningful percentage rent.

16. See supra section 1:3.1.
hazardous materials or conditions, and the like. If there are valuable existing improvements of use to the tenant, the landlord will want these reflected in the rent.\textsuperscript{17}

\textit{Tenant Characteristics.} To an extent, the financial and professional qualifications of the tenant should affect rent determinations, at least in the initial negotiation of the ground lease. The capabilities and experience of the tenant with similar projects, the amount of equity, the extent of pre-leasing will all affect the degree of risk to the landlord, as will the nature of the project itself. Generally there will be less risk to the landlord and more risk to the tenant if the tenant installs higher value improvements.\textsuperscript{18} Usually there will be little if any financial credit provided by the tenant beyond the equity investment in the project.

\textit{Historical Rates.} Carneghi allows\textsuperscript{19} that it is “helpful” to know historical ground lease rates of return and how they reflect economic conditions, while seemingly emphasizing current financial market conditions. However, in the initial lease negotiations, historical rates of return are likely to loom much larger than current, transitory market conditions. When the parties contemplate a term of twenty years or more for a base rent, the fact that market rates are very low or very high by historical standards will probably have no more than a marginal effect on the agreed rate. In almost any market a rate of return (based on land value) of less than 6\% would be low (and probably unattractive to the landowner) and more than 10\% very high (absent subordination)—and probably unattractive to the tenant. Certainly 7\% to 8\% is much more likely (“historically”) to be the basis for an agreement, absent unusual circumstances. And if current market rates—either very high or very low—would not serve as the basis for the initial agreement of the parties, in the context of a subsequent reappraisal they should not be treated with greater respect by the appraisers (unless the reappraisals are very frequent—see below).

\section*{\textsection 2:1.4 Lease Terms Affecting Ground Rent}

There are several terms of the ground lease itself that may affect the base rental rate, these terms affect the value of the ground lease to both the landlord and tenant. Sometimes, the initial base rent will have been agreed to before all these lease terms are fully negotiated (or perhaps understood), in which event the base rent may need to be reconsidered in the course of negotiations.

\textsuperscript{17.} The value of these improvements “owned” by the landlord should also be excluded in any later resetting of the rent. See infra section 2:6.2 regarding the impact of “assemblage value” in later rent adjustments.

\textsuperscript{18.} Carneghi, \textit{supra} note 1, at 258.

\textsuperscript{19.} Carneghi, \textit{supra} note 1, at 256.
Subordination. Subordination, by which the landlord’s fee interest is subjected to the tenant’s project financing, is a major game changer. This should affect the ground lease rental rate, project participation, and other terms, often in unpredictable ways.\textsuperscript{20} Similarly, any “partial subordination”\textsuperscript{21} may also affect ground rent, depending on the degree of risk assumed by the landlord.

Lease Term. A longer lease term, fixed or with options in the tenant to extend, may justify a marginally higher rate of return.\textsuperscript{22} If the initial term is relatively short, but the tenant has a number of options to extend, that is more distinctly to the tenant’s advantage. A unilateral option will always have some value, even when the option is at the market value at the time of exercise.

Rent Structure. The nature and frequency of base rent adjustments may affect the base rate. Frequent (e.g., every five years or more often) CPI adjustments, with or without a cap or a floor, should support a lower base rent. The terms\textsuperscript{23} and frequency of reappraisals should also affect the initial and the reappraised rent. If appraisals are very frequent, then current market rates of return may have greater relevance than historical rates (see discussion at the end of the previous section). Frequent base rent adjustments increase the risk to the tenant.

Landlord Profit Sharing. If the landlord has a valuable share in the project through percentage rents\textsuperscript{24} or equity in the tenant,\textsuperscript{25} the base rent may be justifiably lower, depending on the structure and likelihood that the profit sharing will be meaningful.

Project Start Up. Where the tenant has the right to cancel the agreement before construction begins, or if there is a long start-up and construction period with nominal rent, those may be reflected in a higher base rent when the project begins operations.\textsuperscript{26}

\section*{§ 2:2 Preconstruction Period}

Most often, obtaining rights to the land is only one of several steps the tenant must take before construction of the project can begin. Usually the ground lease is executed prior to the “commencement” of the term; the developer’s right to use or possession of the property prior to commencement may be limited to investigation of soils,
inspection of existing improvements, and similar preconstruction development activities. Depending on the circumstances, the landlord may want the developer to assume the carrying costs of the property as soon as possible, or, if there is some existing revenue or other useful activity, like parking or existing improvements with rent-paying tenants, the landlord may want to continue that use until the last practicable moment.27

§ 2:2.1 The “Option Period”

The preconstruction period is characterized by the tenant’s efforts to fulfill requirements that must be satisfied prior to proceeding with construction of the project, such as obtaining financing, governmental permits and approvals; completion of plans; and the like. The commencement of the term of the ground lease will normally be conditioned upon satisfaction of these conditions, and failure to satisfy one or more conditions will usually provide the tenant, and often the landlord, with the right to terminate the lease.28 In the sense that the tenant will usually have the ability to terminate the ground lease prior to its becoming fully effective if he is unable to meet one or more of the conditions that are solely his responsibility to fulfill (usually to his “satisfaction in tenant’s sole discretion”), the preconstruction period in its nature provides to the tenant something of an “option” to lease the property.

The landlord should be primarily interested in seeing the project go forward on a responsible basis. She does not want the property tied up unless there is a significant probability that the tenant intends to and can proceed. The landlord often requires that specified efforts be undertaken by the tenant to satisfy conditions within defined time frames; otherwise, the landlord may terminate the agreement.29 The landowner should be concerned that the project does not proceed without assurance that all essential elements are in place, even if the tenant/developer is willing to take the risk (as some are) that necessary conditions can be satisfied later.30 But as a general proposition, the tenant/developer needs a wide degree of latitude to decide whether the circumstances justify going ahead with a potentially risky development, often beyond the specifics addressed by the stated conditions, including the developer’s judgment regarding future market conditions prevailing when the project is completed.

27. See infra section 2:2.2[B].
28. See infra chapter 8.
29. See infra sections 8:2.3 and 8:2.5.
30. This is especially true if the fee is to be subordinated to the tenant’s financing. See infra chapter 5.
§ 2:2.2 Rental Considerations

Several factors will affect the determination of rental (if any) during the preconstruction period, which are discussed below.

[A] Tenant Costs

The extent to which the tenant is incurring costs for development of the project, such as architectural and engineering fees for plans and specifications, fees for environmental clearances, and other expenses. The “option to lease” may have value to the tenant; often, however, the tenant is undertaking a substantial risk that the “option” will amount to a liability (or at least a substantial out-of-pocket loss) in the event the project cannot proceed.

[B] Landlord Costs

The holding costs of the property to the landlord, including real estate taxes and assessments and interest on any indebtedness incurred to acquire or carry the property. If the property is currently improved and in use by the landlord, or is leased by the landlord to rent-paying tenants, the property may be producing cash flow so that the “cost” of the “option” granted to the tenant amounts to an opportunity cost (that is, opportunities that may have been lost to the landlord if the tenant does not proceed with the project). If the ground lease provides, for instance, that the tenant can take possession of the property on relatively short notice, then the landlord may also incur a “cost” resulting from her inability to rent space in the existing improvements except on a short-term basis and from not being able to make improvements that would increase the rental value.

If the land is not in use by the landlord, it will often be appropriate for the tenant to bear the carrying costs of the property (or some portion thereof) during the preconstruction period, particularly real estate taxes and, perhaps, assessments, depending upon the magnitude and purpose of the latter.

Often, it is only if the project can be built that the land becomes worth the rents the developer is contracting to pay. The value of the land is established based upon the uses to be made as a result of the development, and usually not the use then made by the landowner. The primary purpose of the preconstruction provisions should be to assure that the developer is proceeding expeditiously to meet the conditions to development of the project.

[C] Work Product; Minimum Expenditures

If the lease never goes into effect (that is, if the developer cannot proceed with the project), at least some of the developer’s work product should be provided to and become the property of the landowner.
Certain types of work product (for example, soil studies, land surveys, hazardous waste studies) will have continuing value [although a future developer of the property will hesitate to rely on studies or surveys that were not specifically commissioned for his project].\textsuperscript{31} Some of the work product, however, may not be transferable to the landowner; for instance, architects usually try to maintain proprietary rights in their plans. It may also be appropriate to provide that if the developer does not undertake at least certain predevelopment work or expend at least a minimum dollar amount for related work, some penalty or other consideration will be payable to the landlord in the event the project does not proceed.\textsuperscript{32}

[D] Length of Option Period

There is no clear answer as to how long the developer should be given to put the project together. The most important factor in most jurisdictions is how long it will take to obtain necessary permits. Permits for many large projects with significant environmental impacts may take years to obtain. The landlord will insist on an outside time limit. The lease should require the tenant to diligently pursue permits and approvals. Some ground leases have several milestones to be met by the developer, such as preliminary plans submitted for the landlord’s approval (to the extent required),\textsuperscript{33} the submission of master use permit application by a subsequent date, etc. If the developer is in fact “diligently pursuing” permits and approvals, and has not been denied any necessary action, he should have the opportunity to continue. In any complex or controversial project, there are likely to be delays occasioned by the need to make changes and resubmit plans.

One or more extensions might be granted to the “diligent” developer upon payment of some amount to the landlord or assumption of additional costs relating to the land, or in consideration of amounts already expended by the tenant. If market conditions or other circumstances render the project unfeasible, so that the developer ceases active development efforts, the landlord should have the option to terminate.

The longest delays are often the result of environmental or permit appeals where there is active opposition to the project. Ultimate appeals through land use authorities and to the courts may extend

\begin{footnotesize}
\begin{enumerate}
\item See infra section 9:2.5.
\item See infra section 8:2.3. These provisions may also serve in some jurisdictions to provide legal consideration for the tenant’s otherwise “free” option period.
\item See infra section 10:5.
\end{enumerate}
\end{footnotesize}
the project approval period for years. Ultimately, it is the skill of the
developer and his team [architect, consultants, contractor] in man-
aging the permit process—their knowledge beforehand of potentially
controversial project elements, their experience with the process and
the players in the relevant jurisdiction, their judgment regarding
appropriate and necessary compromise, etc.—that will determine
how long the process will take and whether it will be successful. At
some point most prudent landowners will insist on the right to
terminate the ground lease. It may be appropriate in these circum-
stances, if the developer is willing to proceed, for the landowner to bear
some costs as a condition to termination, especially if she contem-
plates another use of the land that may use some of the developer’s
work product to advantage. Alternatively, the developer may have the
right to extend the agreement during appeals upon payment of addi-
tional rent or some other compensation to the landlord. These
provisions may be affected by whether the property can be used at
all profitably in the interim—for short-term rental or parking or the
like—and whether the controversial use proposed by the developer
may be highly desirable for the location with a correspondingly high
ground rent to the landowner.

§ 2:3  Construction Period Rent

The tenant almost always pays all taxes, assessments, and utilities
chargeable to the property during the construction period.34

Minimum rent during the construction period [in addition to taxes,
utilities, and the like] is frequently paid at a reduced rate in compar-
ison to minimum rent during the regular term [after completion of
construction]. Sometimes no minimum rental is payable at all during
the construction period. These matters ultimately depend upon finan-
cing and yield considerations for both the landlord and tenant. “Free”
rent during the construction period will help control project costs and
will facilitate financing and development. This concession by the
landlord should be reflected in future rents or “participation” in the
project after construction is completed.35

34.  See infra section 2:8. Compare the developer’s lease form, supra
section 1:12.

35.  Free or reduced rent during the construction period may be capitalized and
amortized over all or part of the initial lease term. Sanford A. Weiner,
2005] [seminar article], available at www.acrel.org/Documents/Seminars/
2005%20Weiner%20Basic%20ground%20lease%20drafting.pdf. More
often, the free or reduced rent is taken into consideration when setting the
minimum rent schedule in terms of the net present value of the entire rental
stream over the initial term.
The landlord’s land will be committed to the project as a resource used by the developer at least from commencement of construction. The landlord may think that she deserves to receive rent as much as the construction lender deserves interest on funds advanced. The tenant will tend to think that the land is not really earning rent, at least at the contract rate, until he has built the project there. If the construction period is significant, say six months or more, some compromise at a reduced rate is fairly common.

The landlord will usually want “commencement of construction” to occur so that the developer is committed to proceed and complete the project as early as possible, and so that rentals begin at an early date. The developer will generally wish to delay commitments and rental obligations until he is assured that all the critical elements of the project (permits, financing, etc.) are in place. However, the landlord should also wish to be assured that the developer upon “commencement of construction” has obtained financing and permits and all other elements necessary for successful completion of the project. The developer may be willing to undertake the costs and commitments attendant upon early “commencement” rather than permit the ground lease or other commitments to expire, even if all the other pieces are not yet in place. This will be especially true if the tenant is a limited liability entity formed just for the project, with no other credit available to the landlord on the lease. Then the developer only has at risk what he has already spent and his incentives are to roll the dice rather than forfeit his costs to date.

Definitions of “commencement” and “completion of construction” are important if those events trigger payment or other obligations under the ground lease. Sometimes a reduced rental “construction period” may be simply a stated period of time corresponding approximately to the anticipated construction period; often the full rental will be payable upon the earlier to occur of completion of construction or the expiration of the stated time period. The stated time period may be subject to extension for delays in completion that are not the fault of the developer, but often the landlord insists that the full minimum rent must begin at some date certain without regard to construction delays.

Completion of construction may be defined as physical completion of improvements, but it is less subject to controversy if defined as “first occupancy by tenants” or “issuance of certificates of occupancy by appropriate governmental agencies allowing occupancy of the project for its intended uses.” Frequently, a project will be functionally complete while numerous minor construction details (called the “punchlist”) remain and a “final” certificate of occupancy for a multi-tenant project may not be issued for many months after the project is in use. Sometimes the contractor and developer will argue
whether the nature or extent of incomplete items constitutes a punch-list or a failure of “substantial completion.” But from the landlord’s standpoint, occupancy by tenants under even a “temporary” certificate of occupancy should represent completion of construction for purposes of ground rent determinations.36

The parties should also consider the impact of “phasing” construction of projects on the property. It may be appropriate for the minimum rental to reflect the extent of improvements actually completed (or anticipated to be completed) at certain stages during the development process until all the elements of the project are in place, or the parties may agree to a series of ground leases providing for the various phases.37

§ 2:4 Minimum Rent

Minimum rent usually reflects a fixed return based on the agreed value of the land (usually something between 6% to 9% of the fair market value of the land, depending upon prevailing market rates of return and other factors).38 The rental is usually paid in equal monthly installments in cash and on an absolute net basis.39

In a long-term ground lease, almost all the problems associated with minimum rent (sometimes called basic rent, fixed rent, or the like) arise from the landowner’s concern that over the term of the lease (including renewals and extensions) the fixed minimum rental will become inadequate as compensation for the value of the property, due to general inflation (or other factors, such as changes in surrounding land use) that would be expected to occur over many decades.

For this reason, groundowners always expect methods of increasing the minimum rental over the lease term.40 The problems created

36. Appendix A includes definitions of lease commencement (section 1.02), commencement of construction (section 1.02) and completion of construction (section 5.01 at the last sentence of the first grammatical paragraph) that reflect some of these concerns.
37. For multiple parcel development, see infra chapter 21.
38. See supra section 2:1.
39. That is, net of taxes, insurance, utilities, and all other expenses of owning, operating, and maintaining the project.
40. Once it was not uncommon for landlords to require that ground rent be paid in gold specie (when gold was legal tender) on the theory that gold would protect against devaluation of the dollar, that is, inflation. From 1933 until the 1970s, gold clauses in private contracts were invalid. Landlords with 1920s ground leases were required to accept cash for rent, often in fixed amounts that did not change for decades. A few landlords whose leases persisted into the 1970s and beyond were able to obtain some relief after gold clauses were once again permitted. Pre-1933 commercial leases are becoming fairly rare.
by different types of adjustments to minimum rent are addressed in the following sections. However, the conclusion is fairly straightforward: increases in minimum rent that are not reflective of the ability of the project to produce cash flow threaten the feasibility of the project in the first instance, as well as subsequent project refinancing, and should be avoided by ground lease tenants. It has long been recognized that unlimited rent increases by CPI or appraisal may very well render the leasehold unfinanceable.\footnote{See, e.g., Emanuel B. Halper, The Anatomy of a Ground Lease, 3 REAL EST. REV. 9 (1973); David W. Walters, Counseling the Lender on Leasehold Mortgages, 11 PRAC. REAL EST. LAW. 35, 42 [July 1995]; Philip Wong, The Leasehold Mortgage: Now You See It, Now You Don’t, 14 PRAC. REAL EST. LAW. 33, 38 [May 1998].} Partial subordination of such increases may mitigate some of the problems as they relate to debt financing;\footnote{See infra sections 2:7.1 and 6:3.} various compromises to indexing methods may be acceptable to the parties. In major projects, the best approach to maintaining fair rent levels for both the landlord and tenant may be properly structured percentage rentals.\footnote{See infra chapter 3.}

Nevertheless, this is a common breaking point in ground lease negotiations. The landowner insists on a redetermination or other adjustment to the minimum rent at some point (for example, ten or twenty years) by CPI indexing or appraisal. If accepted, this may result in an unfinanceable or unsaleable project for the developer. If no compromise is found, the developer may have to find some less desirable site for his project and the landowner may have to find some less substantial use for her land.

\section*{§ 2:4.1 Landlord’s Commitment}

The landlord needs to recognize that by entering a long-term ground lease under which the tenant develops a commercial real estate project, the land is irrevocably (or nearly so) committed to that project, at least for its economic useful life, that is, the period required to amortize the cost and return sufficient profit to the tenant to induce the tenant to undertake the risks of development.\footnote{Too often the lease term is set at ninety-nine years or some other arbitrary period without much thought to the appropriate length. See infra sections 8:1 and 8:7. Regarding “useful economic life,” see supra section 1:4.2, at note 23.} Once the ground lease is signed and the commitment is made, the landlord has surrendered certain options associated with ownership of the land, including the ability to lease the land at a higher rental representing some other, more profitable use that may arise in the future.

\begin{footnotesize}
\footnote{See infra sections 2:7.1 and 6:3.}
\footnote{See infra chapter 3.}
\footnote{Too often the lease term is set at ninety-nine years or some other arbitrary period without much thought to the appropriate length. See infra sections 8:1 and 8:7. Regarding “useful economic life,” see supra section 1:4.2, at note 23.}
\end{footnotesize}
From the tenant’s perspective, it is important that the lease term, including extensions or renewals, be sufficient to realize appropriate returns on the project investment. Any rental adjustments prior to the end of that minimum period need to recognize that the land has been committed to the project and that the rent cannot be adjusted in an amount that the project cannot afford to pay. The landlord should not insist on unlimited base rent adjustments, for example, by “highest and best use” appraisal, during the early years of the lease. On the other hand, developer/tenants often seek lease terms that far exceed the economic life of the initial project, together with rent structures that are not subject to appropriate adjustments even when the original project has outlived its usefulness.\footnote{45} Once the economic life of the project has run its course, it is important for the landlord that if the tenant is allowed the right to maintain the ground lease, with or without redeveloping the improvements, the rent is adjusted to reflect the then value of the fee interest by periodic reappraisal, percentage rental or other means.\footnote{46}

\section*{§ 2:4.2 Inflation Indexes}

Inflation adjustments based on a consumer price index, construction cost index, or other similar measure are problematic for the developer, his equity partners, and lenders. Changes in the consumer price or another index may or may not bear a relationship to changes in the value of the land or in the ability of the project to generate cash flow to pay the resulting increases. Usually, rentals charged to occupancy tenants in a commercial real estate project cannot be adjusted at anywhere near the frequency necessary to reflect general inflationary price changes. Hotels, of course, can re-price their rooms every night, and apartments and storage facilities may be able to raise rates on a monthly or annual basis (if the markets will permit), but retail and office leases are typically for longer periods—three to seven years or more, in the case of large anchor tenants. Hotel room rates are much more sensitive to market demand than to the operating costs payable by the hotel operator or owner.

Over an extended period, land and rental values should reflect changes in general price levels, but relatively short-term rental factors in specific localities frequently predominate over inflationary factors for a time. Office rents in high-tech markets such as the San Francisco

\footnotesize{\begin{itemize}
\item[] 45. See, for example, the discussion of the developer’s typical retail ground lease form at supra section 1:12.
\item[] 46. See infra sections 4:5 and 4:6. For rental considerations where the tenant undertakes a major project redevelopment, see infra section 10:8.3 and Appendix A, section 4.13.
\end{itemize}}
Bay area rose explosively in the late 1990s, then fell almost as far and as fast following the dot-com bust in 2000. These dramatic movements were nowhere reflected in general price indices. Rental increases and housing prices have priced many people out of the Bay Area in 2015, during a period of very modest general inflation.

Since at least the late 1970s, high rates of inflation tend to produce high interest rates, usually followed by slowing economic growth. During inflationary periods, property operators are likely to be faced with less occupancy tenant demand (due to the slower economy), greater competition for tenants, and higher operating costs (due to inflation). All of these factors tend to reduce net rents to the operator. If the operator is also the tenant under a ground lease, it is at least ironic that the landowner might be entitled at the same time to an increase in minimum ground rent under an inflation index adjustment. Of course, from the landlord’s perspective, the inflation adjustment is necessary to protect the value of her rental income in an inflationary environment.

The other major problem with indexed changes is the inability of the tenant, a lender, or an equity investor (who must take into account the rental expense in valuing the project for purposes of lending or investing) to determine the rental expense payable during all relevant periods. With an indexed minimum rent, future rentals may not only be unrelated to the ability of the project to pay, but are also not determinable for purposes of present valuation. This can be mitigated by providing for a “cap,” that is, a maximum increase, or a “window” with a minimum and maximum increase at specified points during the lease term. Another method sometimes used is to specify that minimum rent will be adjusted at fixed intervals by only a portion of any increase in a specified index, for example, 50% of the CPI.

Minimum rental adjustments are usually at stated intervals, for example, after the first five or ten years from commencement of minimum rent payments, then every fifth year thereafter. Sometimes minimum rent is only subject to adjustment after the first thirty years of the term on the theory that that will permit financing of the initial development, which will not work for the landlord unless there is percentage rent or some other form of project participation, or a schedule of fixed rent increases over the initial term.

For purposes of underwriting valuation, most lenders will assume that the maximum permitted increases will occur in order to provide a

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47. For example, an increase every fifth year equal to the cumulative increase in the CPI during the preceding five years, but not less than 5% or more than 15%. For another method of capping inflation increases, see “Alternative Rental” provisions of infra Appendix A, sections 2.01, 2.02 and 2.03.
“safe” present value appraisal. Equity investors may not be so conservative. But either must attach a significant cost (that is, deduction) to the value of the project as a result of potential increases in minimum rental. Of course, a fee mortgage lender (where the landlord has “subordinated” the fee) may ignore the ground lease rents entirely.

Either a cap or a window should be a concern for the landlord over a long-term lease if there is no other form of rental adjustment or project participation.\textsuperscript{48} Periodic base rental adjustments tied to an inflation index with a reasonable cap or other limitation may best be used in conjunction with a percentage rental structure or with periodic reappraisals.\textsuperscript{49} In smaller projects with a relatively short lease term, where the parties find percentage rent too complicated or otherwise too troublesome, inflation adjustments within a reasonable “window” may be feasible. But then the landlord should insist on a reasonable initial term with appropriate base rent adjustments by appraisal for any extensions.

In setting a cap or a window for CPI adjustments, the parties should be aware that since its inception in 1913, the average annual compounded increase in the CPI has been 3.24%; 3.7% since 1947; and 3.1% since 1987.\textsuperscript{50} There have been much wider variations in the rate of inflation, of course, but they seem ultimately to correct themselves over time to a fairly narrow range. The Federal Reserve is apparently committed to containing price increases in a range of 1% to 2%, and there have been suggestions that inflation is now a “manageable” phenomenon, but one might want to rely more on a hundred years of history than the experience of the last few decades.

Using a cap or a window will also raise the question of whether the cap [or the minimum] should be cumulative. If, for instance, the cap is

\begin{enumerate}
\item[48.] In a lease for a major project with a minimum term of sixty years or more, there is a good probability that at least one high inflationary period, such as the late 1970s when inflation reached 20% per year, will occur. Then, a 3% annual cap, or even 50% of the CPI, will leave the landowner with a much devalued asset.
\item[49.] See “Alternative Rental” provisions of infra Appendix A, sections 2.01, 2.02 and 2.03.
\end{enumerate}
4% per year and inflation during year one is 3% and in year two is 5%, is the adjustment for year two limited to 4% or does the landlord get “credit” for the 1% “shortfall” in year one. Over extended inflationary periods the landlord’s rent can fall a long way behind inflation. Should the rent be allowed to catch up in later years when inflation is below the cap? Mechanically, this can be done simply by referring to the first year of the lease term as the base for all subsequent inflation adjustments. The landlord can argue that the cap, which is for the tenant’s benefit, can be cumulative without harming the tenant’s interests in that most financing sources will assume the base rent is adjusted by the maximum allowed amount, and the tenant has implicitly accepted the cap as a tolerable adjustment.

§ 2:4.3 Other Inflation Adjustments

There may be a variety of dollar amounts specified in a ground lease that should be subject to periodic inflation adjustments, such as insurance policy limits or costs of construction (for example, for alterations or rebuilding). An index tied to construction costs may be appropriate where items such as replacement cost insurance requirements or cost of construction are in question, for example, the Engineering News Record indices.

§ 2:4.4 Step Rents

Step rents provide for specified rent increases at specified times in specified amounts. Fixed steps remove the uncertainty that indexing or appraisal creates with respect to future rentals. The advantage of step rent provisions over indexed adjustments or appraisals is that the increases are known and can be taken into account in determining values for the initial project financing and subsequent refinancing. Step rents are a simple, rough approximation of unpredictable

51. The Alternative Rental provisions of Appendix A provide for reappraisals every twenty years and CPI adjustments every five years in between, with CPI caps of 20% in any five-year period [i.e., 4% per year with no compounding] and 3.5% annual compounded since the last reappraisal. This is a limiting formula for the landlord, somewhat offset by reappraisals every twenty years. The first reappraisal—and perhaps the second as well—might need to be “use value assessments.” See infra section 2:5.4.

future circumstances, which avoid later disputes and accounting and appraisal issues of more sophisticated methods.\textsuperscript{53}

Fixed increases do not truly address the concerns of either the landlord or the tenant under a long-term ground lease. The landlord has no assurance that higher inflation will not reduce even the increased fixed rents to an absurdly low return. The tenant has no assurance that the project will be able to pay the higher rents at a subsequent date (for example, in the event of general disinflation), although it is usually in the tenant's interest to provide small steps in ground rent to the exclusion of indexing, appraisal, or percentage methods.\textsuperscript{54}

Fixed, stepped increases may be workable in shorter-term leases involving smaller projects, or in conjunction with a percentage rent provision or with periodic reappraisals. The increases should be moderate and in line with the developer's (and lender's) pro forma inflation assumptions.\textsuperscript{55}

\section*{§ 2:5 Appraisal Methods}

A third method of adjustment is to provide that, at certain stated intervals (for example, every twenty years or every tenth year after the twentieth year of the lease term), and/or upon commencement of any renewal or extended term, the minimum rent will be adjusted to reflect the then appraised value of the property. This may be based upon a fixed percentage of the then appraised “market value” of the land or it may involve determination by appraisal of the “fair rental value” of the land, which would include determination of the rate of return as well as the market value. While the landlord will generally benefit from more frequent reappraisals, everyone should be aware


\textsuperscript{54} Since the Tax Reform Act of 1984, fixed increases may have another adverse impact on the landlord. The act added Code section 467 providing for accrual of increased rents payable in future years in broad categories where some “tax avoidance” purpose may be found. The effect may be to require that future increased rents be recognized in earlier years. See Malone, \textit{Final Section 467 Regulations}, 27 J. Real Est. Tax’n 65–83 [Winter 2000]. Similarly, generally accepted accounting principles may require reporting rental income and expense on a straight line or other basis.

\textsuperscript{55} See infra Appendix A, section 2.02.3. Step rent increases, usually at a low rate, for example, 1% per year or 5% per 5 years, are a typical proposal by some developers in lieu of other adjustments over long-term ground leases. See supra section 1:12. The same developers are likely using higher rates of inflation in their project pro formas.
that these tend to be contentious battles pitting opposing lawyers and appraisers in protracted arguments involving lots of expense.  

A rate of return may be specified in the ground lease that must be applied to the fair market value of the land as determined by the appraisers, for example, 7% or 8% for the new base rent going forward. This practice gives the parties some assurance that the rent will be within a reasonable range in the future, notwithstanding potentially wide market swings in rates of return for various investments. Reported market capitalization rates for commercial real estate can vary dramatically in just a few years. This sort of information, however, is largely anecdotal; there is little reliable, independent data relating to commercial real estate transactions in most markets. Even so, if the appraisers are charged to find an appropriate rate, market conditions at the time of the determination, while relevant, should not control if then prevailing rates of return or “cap” rates do not reflect historical averages, especially where the new base rental rate will affect rent for a number of years. If reappraisals occur every five years (which is relatively uncommon), then current market rates might be of greater relative importance. Much more often the reappraisal will establish a base rate for ten years or more, as much as twenty-five years. Given this issue, specifying a rate of return within a reasonable range may be prudent.

Sometimes, rather than specifying a rate, some other index or rate is identified (for example, a ten-year treasury rate plus 4%). But in any case, there is a substantial risk for both parties that, at the time of resetting the rent, the specified rate will not reflect prevailing real estate market conditions. In early 2009 and continuing at least to 2015, treasury rates reached historic lows in reaction to the recession, fears of financial system failure, and the effects of remedial measures, so that any reference to treasury rates would likely have had unintended results. While appraisers will usually have little trouble finding comparable sales and other data to establish fair market land value within a relevant market area, there may be few, if any, “comparable” ground lease rates of return in most geographic areas, another good reason for specifying an agreed rate of return on the land value.

The second fundamental problem in the appraisal approach is the possibility that, because of changes in land use patterns,
transportation facilities, zoning, or other economic factors over the period between the initial negotiation of the lease and the reappraisal, the land value may change dramatically, while the value of the tenant’s project on the premises does not experience the same change.\textsuperscript{60} Property that was committed to low or midrise office use may, ten or twenty years later, be appropriate for high-rise office buildings, apartments, or condominiums. Instead of land value of, for instance, $50 per square foot, the value might be $400 per square foot or more; and the existing use will simply not be able to pay any “reasonable” return on the then “fair market value” of the land if determined without regard to the use to which the land is then dedicated. Most developers and lenders are simply not willing to take that sort of risk (even though it may seem largely theoretical).\textsuperscript{61} The landowner has to share in risks created by using the land for a specific type of project, a decision in which she is a participant and beneficiary at the time the ground lease is executed, at least for the minimum period required by the tenant to realize the expected return from the project.\textsuperscript{62}

As the project ages, it may become less able to pay a competitive economic rent for the land. Near the end of its economic life, the renewal decision may be difficult for the tenant, especially if a reappraisal or similar reassessment of the rent is required. It may be appropriate to allow the tenant wider latitude in renovating and adapting the improvements to then prevailing conditions so that the project may be able to pay a reappraised, higher rent, especially if the landlord does not then have an immediate higher or better use for the property. In connection with remote renewal options, the tenant might have the absolute right to renew at the reappraised rent (or the landlord might have the option to buy out the tenant if there is a better long-term use); or the tenant might propose renovations and/or alterations of use as a basis for a greater rent (perhaps with a longer extension of the term), in which event the landlord might have the right to either accept the tenant’s proposal, allow renewal at the lower rent for a shorter renewal term, or elect to terminate the lease. Technological obsolescence may shorten the useful economic life of

\begin{footnotes}
\footnote{60}{See Hecht, \textit{supra} note 53, at 677.}
\footnote{61}{The author is aware of one such determination where the new ground rent was set by the appraisers based on an achievable density of two million square feet, even though the existing improvements built by the tenant were barely one-quarter that size. The existing improvements were far from the end of their useful life and no one would have suggested replacement. This uneconomic result was said to be compelled by the lease language. \textit{See infra} section 2:6.2.}
\footnote{62}{\textit{See supra} section 1:4.2, at note 23, and \textit{infra} section 8:7.1. For a number of sobering decisions, \textit{see infra} section 2:6.2.}
\end{footnotes}
many real estate projects, in which event the ability to adjust and adapt will become critical to long-term lease arrangements.  

§ 2:5.1 Relation to Length of Term

The determination of rent adjustments during the original term, or for a renewal term, should depend in part on the length of the ground lease. If the initial term of the lease is less than the economic useful life of the project, the renewal rent may need to be a continuation of the same rental that was payable during the initial term. If the initial term is longer than the economic life of the project, interim adjustments by appraisal or the like before the end of the initial term may be required to protect the landowner.

A properly structured percentage rental might provide an adequate basis for the renewal rent without material adjustments to the base rent. However, if the existing project cannot produce sufficient revenue to pay ground rent based on highest and best use, when the ground lease term (as extended) exceeds the economic useful life of the improvements, a percentage rent clause will not help.

Of course, renewal rent can be adjusted by any of the methods described above for increases in basic rent during the initial term. Some such adjustments may also be applicable during renewal terms. Sometimes the tenant/developer seeks a series of renewal options at the original rent structure for periods that clearly exceed the useful life of the original project, usually in conjunction with the right to redevelop the property for whatever purposes may later be to the tenant's advantage. This amounts to a future ground lease at the sole option of the tenant and—in all probability—at a rent that does not reflect the then value of the landowner's interest.

Once the term of the ground lease extends for substantially the expected useful life of the project, then renewal rent should reflect the value of the land for its highest and best use. If the project cannot afford to pay the fair rental value of the land, or if the developer/tenant does not have a plan to redevelop the property to a use that can justify the rent, then the lease should terminate, permitting the redevelopment of the property.

§ 2:5.2 No Change in Use

Ideally, the ground lease should have an initial term roughly equivalent to the economic life of the project, with a minimum and

63. For a related discussion and other suggestions, see infra section 10:8 and Appendix A, section 4.13.
64. See Peter S. Brooks, Resolution of Renewal Rentals in Land Leases, REAL ESTATE REV. 32–38 (Fall 1996).
65. Not unusual in retail developers’ form leases; see supra section 1:12.
percentage rent structure that obviates the need for a reappraisal of minimum rent during that term. However, many landowners are simply not willing to lease the property for a term of many years without a “fresh” look at the minimum rent. One compromise may be a provision for periodic reappraisals based on the then market value of the land for the existing use and with the existing improvements. This approach may be manageable for interim base rent adjustments during the initial term, or for renewal rent determinations if the initial term is materially shorter than the useful life of the project.66

If the use or size of the project does change significantly, then a reappraisal of the basic rent based on the revised project may be appropriate. Such a change in the project may require the consent of the landlord, who should then be able to require appropriate rent adjustments as a condition to approval. However, if the ground lease allows the tenant to change the use or add to the improvements without the landlord’s consent, then, in connection with the changes, the lease should mandate a reappraisal of basic rent and, perhaps, a new look at percentage rent to reflect the altered use.67

Where the lease provides for percentage rent, the ground lease might provide an effective adjustment mechanism periodically changing the minimum rent to reflect both the minimum and any percentage rent or other participation payable to the landlord under terms of the ground lease that are generated by performance of the project. If the project is comfortably paying both basic and percentage rent over a period of several years, then a new minimum rent reflecting the total payments may be workable, that is, a minimum rent including some portion of the percentage rent earned in preceding years, for example, 50% of the average percentage rent paid in the five preceding lease years. A formal appraisal process should not be necessary when a simple mathematical calculation will achieve the same purpose. The percentage rent calculation following the adjustment would need to reflect the new higher minimum, which should leave some room for possible reductions in subsequent years.

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66. See infra sections 2:5.3 and 2:5.4. A form of lease clause addressing these issues is included as an alternative to section 2.08.1 of Appendix A.

67. See infra sections 10:8.3, 11:3, and Appendix A, section 4.13. For a list of landlord considerations where minimum rent is based on the available floor area the tenant may construct on the land, see Barry C. Ross, Checklist of Critical Issues for Fee Owner’s Consideration, in COMMERCIAL REAL ESTATE FINANCING 2007, PLI Course Handbook, 2007. Where the landlord’s consent to a change in use is required to be “reasonable,” the lease should specifically authorize her to seek a reconsideration of the rent as a condition to her consent. Otherwise, seeking a rent increase as a condition to her consent may be deemed “unreasonable” under local law.
if the project has a reversal of fortune (for example, due to age or
market conditions) and no longer is able to pay all of the higher rent. 68

§ 2:5.3 Value Based on Existing Improvements

If the parties have agreed to an initial lease term that is shorter than
the expected economic life of the project, or for interim adjustments
during the term prior to the end of the expected economic life, an
alternative approach is to provide that the ground rent will be the
market rent for the land as improved with the existing structures
(a “use value assessment” 69), taking into account the remaining length
of the term. That determination may further take into account
whatever refurbishing or restoration of the improvements by the
tenant would be prudent and profitable with respect to the renewal
term (excluding demolition and construction of an entirely new
project), whether or not the tenant undertakes such restoration, and
should be based upon the assumption that the improvements are in
first class condition (or whatever condition the lease would then
require), regardless of the actual condition. It may be relevant whether,
under the lease terms, the tenant has the right to alter or reconstruct
and/or change the use of the existing improvements to improve
economic performance. 70

The lease might also provide that the renewal rental would be based
upon the then current improvements existing on the premises, rather
than the potential highest and best use of the land, if the tenant has in
fact performed a major refurbishing or renovation of the improve-
ments within some period prior to renewal (say, five or ten years) or
undertakes to do so upon renewal (and, in fact, does so).

There is little in law or practice developing this idea. The approach
might suggest the use of “residual land valuation” techniques, where
the underlying land value is inferred from the cost of other elements of
the project. Appraisers tend to follow their existing methods; residual
land value is not a standard appraisal technique, but comparable sales
and income capitalization are. The effectiveness of this method may
depend upon the language used in the revaluation clause. 71

68. For an alternative approach, see infra section 3:2.11.
69. See infra section 2:5.4.
70. For a suggested lease clause, see infra Appendix A, section 2.08.1.
§ 2:5.4 Residual Land Value and Use Value Assessment

It has been suggested several times in this chapter that a potentially serious problem will be created if the ground lease rent is open to reappraisal prior to the end of the economic useful life of the project to be developed by the tenant. The project, following adjustment of the rent to reflect the highest and best use of the land, may no longer be able to afford the higher rent [at least without impacting the cash flow needed to pay lenders and equity investors]. For instance, a 100,000 square foot office building might be constructed as permitted by legal and/or market constraints; twenty years later, due to changes in zoning or market conditions or both, the highest and best use might be a two million square foot multi-use complex. This can be a significant issue even at commencement of the ground lease, as increasingly sophisticated lenders and investors may decide that the potential problem affects financeability of the project.

Landlords, however, often insist upon reappraisal of the land value at a relatively early date, especially for larger projects where the useful life is at the longer end of the scale, as a price for agreeing to the lease. This is often a crucial point in the lease negotiations and can be a deal breaker. One resolution suggested above is to revalue the land based on the continuing existence of the then improvements, a notion sometimes analogized to a technique called “residual land valuation.”

72. The author is indebted to Anthony Gibbons, MAI, CRE, RE-SOLVE, Gibbons & Riley PLLC, Bainbridge Island, Washington, for his guidance and suggestions that are incorporated in the following discussion.

73. Generally both the landlord and the developer/tenant will want to develop the maximum permitted density on the ground leased parcel, and if that is more than the developer thinks the market can absorb, then they will undertake a subdivision of the land to create the right sized lot. The ground lease may require the tenant to build to maximum density. That still leaves the possibility of zoning changes and market transformations affecting value. See cases at infra section 2:6.2. Regarding transfers of unused development rights, see infra Appendix A, section 1.06.

74. It is one argument of this book that the need for periodic reappraisals of ground rent can be obviated by a properly structured percentage rent. See infra chapter 3. This approach is often rejected due to the perceived complexities.

75. The landlord is not asking for something that she does not need or is not entitled to, which distinguishes this problem from that raised by the developer who seeks optional renewals at a fixed rent that can extend the term long past the economic useful life of the initial project. See supra section 1:12.

76. See supra section 2:5.3.
Residual land valuation is sometimes described by the deceptively simple proposition that the value of the land equals the value of the completed development, less the development costs (actual or projected, or, in the case of an existing project, the replacement cost) and the developer’s profit.\textsuperscript{77} This formulation, however, requires a vast amount of data to reach its conclusions and is no panacea for land value issues. Even if development or replacement costs are relatively objective [and the projection of those relatively objective figures will be a significant task], project value and appropriate developer’s profit [and investor returns] will remain highly problematic. The results, that is, the residual value assigned to the land, will be very sensitive to many assumptions regarding costs, rates of return, interest rates, discount and capitalization rates, market conditions for the project going forward, and numerous other factors. For that reason, the technique is subject to manipulation by whomever is running the numbers, for example, a developer trying to convince a landowner that her property is not as valuable as she thinks or vice versa. Comparable sales data, if available, often openly contradicts the theoretical results of residual valuation.\textsuperscript{77.1}

Other terminology may provide a better basis for the determination contemplated in these circumstances. “Use value assessment” is defined\textsuperscript{78} as “[a]n assessment based on the value of property as it is currently used, not on its market value considering alternative uses . . . .” This terminology would not exclude residual valuation, but would also admit other techniques, such as comparable sales, that might be better indicators of land value depending on the circumstances. “Use value assessment” still involves variables and difficulties, and it is more a goal than a technique. However, at least from the tenant’s standpoint with respect to an interim land rent reevaluation, the concept should be a much better alternative to “highest and best use as though vacant.” Residual value, on the other hand, has limited recognition legally\textsuperscript{79} or within the appraisal profession,\textsuperscript{80} and has long been recognized as problematic and subject to manipulation.\textsuperscript{81}

\begin{itemize}
\item \textsuperscript{77} See \textit{Appraisal Institute, The Appraisal of Real Estate} 341 [12th ed. 2001] [hereinafter \textit{The Appraisal of Real Estate}].
\item \textsuperscript{78} \textit{Appraisal Institute, Dictionary of Real Estate Appraisal} [3d ed. 1993].
\item \textsuperscript{79} See note 53, at 641.
\item \textsuperscript{80} See \textit{The Appraisal of Real Estate, supra} note 77, at 341.
\item \textsuperscript{81} See Hecht, supra note 53, at 641.
\end{itemize}
§ 2.6 Renewal Rent

§ 2.6.1 Legal Issues

There should be either a definite stated renewal rent in the ground lease or a procedure for determining rental pursuant to defined standards. The majority rule is that indefinite or uncertain rental provisions with respect to options to renew will render the option unenforceable as an “agreement to agree.”82 A minority rule in some states holds that renewal agreements that are vague with respect to rental will be interpreted to call for a reasonable market rental to be fixed by the trial court if the parties are unable to agree.83 Courts in a “respectable minority” of states have enforced renewal clauses including such phrases as rental “acceptable to lessors,” “as may be agreed upon,” or “rental to be negotiated.”84

However, this is not only an issue of enforceability; even in this respectable minority of states, the basis for determining renewal rent should be made as specific as practical to protect both parties.85 If the rental upon renewal is to be determined by arbitration, appraisal, or similar means, then the tenant should not be required to exercise the option to renew irrevocably until after the renewal rental has been determined. A preliminary notice of intent to renew by the tenant should be required, followed by a determination of the rent payable for the renewal term, with a final opportunity by the tenant to decide whether or not to enter into the extended term.86

Generally, a provision requiring arbitration if the parties cannot agree on renewal rent should be enforceable.87 Whatever basis is

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83. A California court held that a renewal option at “market rent” provided “an ascertainable standard for determination of rent” and was enforceable. Miner v. Tustin Ave. Investors, 10 Cal. Rptr. 3d 178, 184 [Ct. App. 2004].
85. For instance, a casual description such as “in accordance with standard appraisal methods,” will probably compel an appraisal at “highest and best use.” See infra section 2:6.2.
86. See infra Appendix A, section 2.08.1.
chosen for determining renewal rent (for example, highest and best use; existing improvements; “fair market value” of land, etc.), there will be substantial room for the parties and their experts to disagree. The renewal rent provision should be as specific as possible, with as much guidance to the arbitrators or appraisers as feasible.88

If the landlord fails to request any rental adjustment provided by the lease in a timely manner, might she be deemed to have waived any increase? In an Idaho case, the lease provided for reevaluations of the land every three years, which the landlord failed to request for twenty-three years, until a new tenant acquired the leasehold; the court found no evidence of either waiver or estoppel, only neglect.89

§ 2:6.2 Basis of Renewal Rent

“Reasonable Rental.” Even where the courts will undertake to determine a reasonable rental (as under the minority rule), or where the parties have provided for the determination of a reasonable rental but have failed to specify the basis upon which it is to be determined, there is relatively little comfort for the tenant or the tenant’s sources of financing if the basis upon which the new rent is to be determined is not described. Will this “reasonable rental” be one that the tenant’s project can afford to pay? Is the determination of the value of the land to be made based upon the continuing existence of the ground lease and the improvements and uses provided for in the ground lease, or is the land to be valued as unimproved and unencumbered at its highest and best use? The answers to these questions should depend upon the length of the preceding term and the expected economic life of the tenant’s improvements.90 But where the lease requires renewal rent to be based on the “appraised value of the land,”91 or requires a “reasonable rent”92 under the law and established appraisal practice, the valuation will reflect the value of the land at its highest and best use without regard to the value or kind of improvements owned by the

88. See infra chapter 22. An appraisal proceeding rather than arbitration may be less contentious and expensive for this purpose. For a detailed specification of appraisal criteria for the determination of an option purchase price, see infra Appendix A, Exhibit D. See infra section 22:5 regarding judicial review of arbitration decisions.

89. Pocatello Hosp. LLC v. Quail Ridge Med. Inv., LLC, No. 40566 [Idaho Aug. 1, 2014]; 39 NAT’L PROP. L. DIG., no. 11, 172–73 [Sept. 2014]. Of course, the ruling was in favor of the hospital against private investors, raising the rent from $9,562 to $148,500 annually and providing for three years of back rent totaling $416,812. A different result might have been compelled if the acquiring new tenant had required a typical estoppel certificate from the landlord. See infra section 4:10.

90. See supra section 2:5.1.


92. Murrey v. Odman, 96 P.2d 489, 492 [Wash. 1939].
tenant or the economic life of the project. Of course, the renewal rent should take into account the property that each of the landlord and tenant owns: the rent should not be based on the value of the improvements built by the tenant, but only the land owned by the landlord and the continuing value of any improvements owned by the landlord at the commencement of the lease that are utilized by the tenant in the project.

**Effective Date.** The lease should specify as of when value is to be determined. This is a matter of the intent of the parties, but is presumably not the date when the renewal option is exercised or when the appraisers meet, but rather the beginning of the renewal term, that is, usually a prospective valuation. There can be a significant time difference between an option exercise with respect to a substantial ground lease and the actual commencement of the extended term.  

In fact, it is not uncommon, after the parties have argued for some time about the appropriate rental rate, for the arbitrators or the court to make the determination long after the beginning of the extended term.

**Use Restrictions.** In *Ruth v. S.Z.B. Corp.*, 94 it was held that the land was to be valued without regard to the restrictions on use contained in the underlying lease. The lease provided that rent would be based upon the “full and fair value of the land demised that the same would sell for as one parcel considered as vacant and unimproved, in fee simple, by private contract, free of lease and unencumbered.” However, *Plaza Hotel Associates v. Wellington Associates* 95 held that valuation of the land must take into “consideration all encumbrances thereon, including the restrictions as to its use, unless there is a clear provision to the contrary,” where the lease provided that the rent would be based on “the value of the land [whenever permitted by the context the word ‘land’ is herein used as intended to mean the land only, exclusive of the buildings and improvements thereon] as of the date of commencement of the term of this lease.” Use restrictions contained in the lease itself may prohibit an appraisal based on the highest and best use, 96 unless the lease clearly provides that the value of the land will be free of the lease.

**Downzoning.** If changes in zoning or other applicable laws have restricted the property since the current improvements and use were established, the appraisal would then reflect the current zoning or

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other restrictions, presumably at a lower value. There is a hotel in Seattle built on pilings over Elliott Bay, and condominiums and hotels in Honolulu on the shoreline near Diamond Head, none of which could be built today under existing laws and zoning codes. If the existing improvements are grandfathered under restrictive zoning, the continuing more profitable use should be reflected in the ground rent, at least as long as the grandfathered use is maintained. The ground lease should state clearly what the parties intend; a properly drafted lease will not leave this issue to interpretation.

Assemblage Value. If the ground leased parcel is part of a larger site, so that other property not subject to the ground lease at issue is used in connection with the project, there may be a question of “assemblage value.” The other property may be critical to the project (for example, where the principal improvements are constructed on two or more parcels), or only incidental (for example, adjacent parking not required to meet zoning or other legal requirements for the project). In any event, it will usually be the case that the value of the subject property is increased by its use in conjunction with the other parcel or parcels, so that the tenant may wish to exclude assemblage value in the assessment, and the landlord will want it reflected (even though it is not property that the landlord owns). This will also be a question of the intent of the parties as reflected in the language of the lease and the circumstances. The terms on which the tenant/developer acquired and holds the other parcels may be relevant. But generally, “highest and best use” will allow consideration of value added by using the subject property as part of a larger parcel. If, for

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97. 201–203 Lexington Ave. Corp. v. 205/215 Lexington L.P., 637 N.Y.S.2d 125, 126 (1996), where the lease required the land to be “considered as vacant and unimproved, unencumbered by this lease,” was held to require a valuation based on then current zoning, which allowed a building less than half the size of the one then on the property; Humphries Invs., Inc. v. Walsh, 248 Cal. Rptr. 800, 805 (Ct. App. 1988), where fair market value required consideration of legal impediments to a change in use; N.Y. Overnight Partners, 673 N.E.2d 123; Joshua Stein, A Guide to Ground Leases, ALI-ABA (2005), at 243–45. In a Hawaii case, a hotel built in the 1960s before restrictive zoning covered the entire lot, achieved a floor area ratio (FAR) of 19. Subsequent zoning imposed a twenty-five-foot height limitation and a 0.8 FAR, profoundly affecting, in theory, the value of the land alone on a highest and best use basis. See Press Release, Counselors of Real Estate, Leaseholds, Litigation & Arbitration (Nov. 30, 2006), available at www.cre.org/newsroom/news_article.cfm?lid=1064.

98. For a “downzoning alternative,” see the end of section 2.08.1, infra Appendix A.

99. For issues relating to the ownership structure upon expiration or other termination of the ground lease, see infra section 18:9.
instance, improvements such as parking on the adjacent property permits a larger project to be built on the ground lease parcel, the impact on value could be significant.

*Drafting.* In general, the valuation of the landowner’s property for purposes of renewal rent may be done just about any way the parties agree, reflecting their respective investments in the project, the likely useful economic life of the improvements, and the point during the term when the determination will be made; that agreement should be spelled out carefully in the lease.100 It is, however, often difficult to anticipate how future generations will understand the language crafted years before, and any ambiguity may fuel a major controversy at the time of the reappraisal. Appraisers themselves are prone to think that they know how best to value real estate, without regard to what the parties may have agreed. It is far better to spell out as nearly as possible the basis of any future rent determination than to leave the matter wholly to the whim of a panel of appraisers or a court.

There may be unintended legal consequences to the terms used to describe the revised rent in any particular jurisdiction. In California, rent based on the “fair market value of the land” may mean value determined at its highest and best use, but “fair market rental value of the land” may mean value based on the purposes for which the land is leased.101

A Texas case demonstrates the (perhaps) unintended consequences of lease language, even though the language appears to have been given some thought.102 A rent adjustment was to be a fixed percent of “the appraised value of the property,” determined by appraisers “familiar with the value of real estate in the area,” and taking “into consideration that an office building has been erected on said property and that said property has been dedicated to use as a site for an office building.”103 The tenant argued for a residual land value technique (to determine the value of the land for the specific project) while the landlord offered evidence of comparable sales of property in the area. The court noted that standard appraisal techniques do not include residual land valuation, that the requirement of appraisers familiar with real estate in the area meant that the parties contemplated that

100. The valuation of the landlord’s land for purposes of an option to purchase is in important respects a different matter. See infra section 19:4.3. For a review of the potential meanings of “value” in several contexts, see FRIEDMAN ON LEASES, supra note 59, § 26:5.8, n.192 (Supp. July 2013).

101. Westreich, Determining Rent for Lease Options Based Upon Fair Market Rental Value—Wu’s Choice, 9 CAL. REAL PROP. J. 14, 15 [Summer 1991].


103. Id. at 823.
area real estate values would be considered, and that comparable sales would reflect that intent but residual value analysis would not.\textsuperscript{104} The need to consider that “an” office building would be built did not require that “the” office building be considered; it was enough that the comparable sales data was adjusted for office use. Tenant/developers might consider this another case of the courts protecting the unsophisticated landowner or, perhaps, the futility of hiring lawyers to write agreements that say what you mean.

\textbf{§ 2:7 Minimum Rent Adjustments}

Most methods of adjusting minimum rent during the initial term of the ground lease suffer from the same basic flaw: the increases in minimum rent are determined independently of the value of the project, which is the only source available to pay the ground rent and the other costs that must be paid, including operating expenses and debt service. In almost all cases, minimum ground rent will be payable prior to any kind of return to equity owners in the project, and usually even prior to debt service on mortgage indebtedness (unless the fee is subordinated). Increases in the minimum rent assure the landlord a first-priority return on investment in the project, even though the land may represent a relatively small fraction of the total value of the project, before any return to the other investors in the project, who may have taken substantially greater risks and contributed substantially greater value.

Certain rent adjustments, and variations of each, may impact lenders, on the one hand, and equity investors (including the developer), on the other, very differently. The fee mortgagee is not particularly concerned with ground rent because, if foreclosure becomes necessary, he can take (or sell) the property free of the ground lease. The tenant may need to be more generous with the landlord who is subordinating the fee, and should have a larger mortgage on better terms as compensation. The leasehold mortgagee may be satisfied by placing caps or other limits on rental increases, or by a waiver or deferral of rent increases if the mortgagee must take possession of the property.\textsuperscript{105}

\textsuperscript{104.} \textit{Id.} at 824. Both parties’ arguments may have been wrong. The intent of the original parties might have been better identified as a “use value assessment.” See supra section 2:5.4.

Even so, these provisions may create issues for the developer or potential equity investors that can affect the feasibility of the project. The lender may allow for maximum rental increases and therefore reduce the amount he is willing to lend to the project on a leasehold mortgage. This may discourage equity investors or require greater equity investment than the developer/tenant is able or willing to raise, with the resulting dilution to the developer’s project equity.

§ 2:7.1 Lender Priority

If minimum ground rental (including any increases resulting from midterm adjustments) must be paid without regard to whether or not the mortgage lenders who finance the project are paid (as is the case in leasehold financing, but not with “subordinated fee financing”), any increases in minimum rent, including increases resulting from appraisal or indexing, will diminish the value of the property as collateral for mortgage lending purposes. It is possible, however, to “subordinate” all or some portion of minimum rent (such as increases resulting from indexing or appraisal) to the lien of leasehold mortgage financing. The subordination would become effective only if the mortgagee or another purchaser at a foreclosure sale becomes owner of the leasehold estate, and may be limited in amount and/or duration.

Similarly, increases in minimum rent will affect value for potential equity investors. Such increases could, in theory, be made payable only after (or pro rata in proportion with) an agreed level of return to equity investment in the project (although this is rare at best). In this event, a portion of the landlord’s interest in the project becomes very like equity and few landlords would take this notion seriously.

§ 2:7.2 Occupancy Tenant Pass-Throughs

Developers usually write occupancy subleases for office and retail tenants that include “operating cost” escalation or pass-through clauses covering most property operating costs and taxes (excluding debt service and most capital costs). In theory, it would be possible to cover increases in minimum ground rent as well. If all occupancy tenants accepted such a clause and the property was fully leased, then increases would not hurt the developer or his lender. If the project is not fully leased, then the developer would have to bear the cost

106. See infra sections 4:4 and 4:5.
107. For a discussion of “partial subordination,” see infra section 6:3.
108. Although local practices vary, typically office leases cover increases in taxes and operating costs after the initial or base year of the term, while many retail leases cover all operating costs, taxes and common area expenses from the beginning of the term.

(Whalen, Rel. #4, 8/15) 2–33
increases only for the vacant space. However, sophisticated occupancy tenants will object to this pass-through as a matter of principle, in that ground rent is not an operating cost, but rather a cost of financing the original improvements, like debt service, from the occupancy tenant’s viewpoint; and (2) because the costs are potentially unlimited (the same objection that the developer and his lender have).

The biggest problem for the developer is that the pass-through of ground rental increases may not reflect the fair market rental value of the occupancy tenant’s premises. Since commercial occupancy rents tend to be highly market-sensitive, most developers (and their lenders and investors) will not rely on their ability to pass through this expense in competition with owners of commercial space who do not have the same costs, that is, who own the fee.

§ 2:8 Taxes and Other Payments

Once the lease has commenced, the tenant will be required to pay all the expenses associated with the property, including real property taxes and assessments, utilities, and the like. If payment to third parties of taxes, insurance, utilities, and other amounts required to be paid by the tenant are denominated “rent” in the lease, or if the lease otherwise makes nonpayment of such amounts a basis of forfeiture, the landlord may bring unlawful detainer or similar proceedings for nonpayment. 109

Generally, a covenant to pay taxes does not include taxes on the rent paid to the landlord. 110 But other issues can arise that may deserve attention, especially in jurisdictions where limits on property taxes may give rise to other fees and impositions by creative local governments. 111

Sometimes it seems fair to the parties that the landlord should pay the real estate taxes based on the value of the land, and the tenant should pay the real estate taxes based on the value of the building, but this provision can create difficulties. Generally, taxes will be assessed against the land and the tenant’s improvements together (although separate values may be stated), and will constitute a lien and be enforceable against all of the property, regardless of what the lease says. Lease provisions allocating liability for the payment of property taxes and other assessments and charges should be carefully drafted to avoid conflicts or issues.

109. FRIEDMAN ON LEASES, supra note 59, § 5:1.1 nn.30–32 (Supp. Mar. 2015). Repayment of borrowed money held not “rent” where the issue was the priority of the landlord’s claim against the rights of the leasehold mortgage. Id. at n.33.

110. Id. at n.96.

111. For a sample clause to pick up new taxes, fees, and charges, see FRIEDMAN ON LEASES, supra note 59, § 5:2.1 (Supp. Mar. 2015).
taxes will bind the parties, but not the taxing authority. The tenant’s leasehold lender will not be happy if the landlord is left to pay the land taxes, and will likely insist on an escrow of a portion of the ground rent sufficient to secure timely payment.

§ 2:8.1 Deferred Taxes

Some jurisdictions will abate a portion of real property taxes (for example, provide that assessed valuation be established at less than the “highest and best use”) to encourage continuance of properties in certain preferred uses (for example, agricultural, historical, forestry, greenbelt, etc.). When the property is subsequently developed, the taxes that have been avoided for some prior period (for example, three to ten years) may then be payable, with or without interest or penalties, to the extent that the preferential valuations reduced prior taxes. The landlord will view these catch-up taxes as a cost incident to development (but the tenant will see them as a subsidy to the landowner while carrying the property). They are frequently overlooked until after the lease is signed and a substantial tax bill is presented to the parties, but a good preliminary title report should note any special classification of the property that might result in acceleration of deferred taxes (although it may require a special endorsement to the title policy).

§ 2:8.2 Assessments

Assessments against the land for local improvements are frequently payable in installments over extended periods. Part of the consideration of title matters should include the responsibility to pay assessments, particularly at the beginning and end of the term, including proration of interest charges. Many lenders will insist that assessments be paid off in their entirety prior to funding mortgage loans; most assessments, like regular property taxes, have priority over the mortgage loan (fee or leasehold). Occasionally an existing assessment represents a prior expense with little or no current value to the property and the developer will insist that the landlord pay it off. More often, the tenant will assume responsibility for paying assessments, which if material in amount should be taken into account in determining the rental value of the land.113


113. For a discussion of improvement assessments arising in connection with development of the property, see infra section 10:2.2.
A lease requiring the tenant to pay “all of the real property taxes” did not obligate the tenant to pay a special assessment for the cost of improving an adjacent street.\textsuperscript{114} The lease should be clear regarding the tenant’s (and the landlord’s) responsibility for assessments. The tenant should be responsible for any assessments that arise due to his development of the property. Financing sources may require these amounts to be paid in full even where installment payments are available. If there is an assessment during the term for improvements to or directly benefiting the property, payable in installments extending past the termination of the ground lease, the tenant may be obligated to pay off the balance upon termination of the lease. This is one of those matters that does not receive much attention because it arises so far in the future. Depending on the purpose of the assessment, the property may be materially benefited by the improvement upon expiration of the lease and it may be that the landowner should at least pay the installments due after termination.

Current assessments should be disclosed by a title search. Pending or proposed future assessments should be disclosed routinely or by special searches or inquiries. Tenant’s counsel should be aware of the practice in the relevant jurisdiction.

\section*{§ 2:8.3 \textit{Apportionment}}

Often the ground lease parcel is part of a larger tax lot and must be segregated. There is some law that it is the landlord’s obligation to obtain apportionment where the lease requires the tenant to pay the taxes on the leased parcel.\textsuperscript{115} In a developmental ground lease, the tenant will usually be required to obtain the separate tax lot designation and will want to control the segregation as part of the land use and permit approval process arising, in most jurisdictions, upon the segregation of the parcels (if not sooner).\textsuperscript{116} Typically, the ground lease may not legally become effective until the leased property is a separate legal lot.

\section*{§ 2:8.4 \textit{Tax Appeals}}

A tenant under a net lease was required to pay taxes on the building it occupied and a share of taxes on common areas. A New Jersey court held the tenant had standing to appeal an assessment for municipal taxes.\textsuperscript{117} The ground lease should be specific regarding the tenant’s

\textsuperscript{115} \textsc{Friedman on Leases}, supra note 59, § 5:2.1, n.81 (Supp. Mar. 2015).
\textsuperscript{116} See infra section 10:2. In the air and development rights context, see infra section 20:6.
right to appeal (and pay the related expenses) and should require the
tenant to post a bond or provide other assurance of ultimate payment.
The landlord should cooperate in the appeal, if required, at the
tenant’s expense. If the landlord wants to participate actively,
that is, with her own counsel, the landlord should pay that expense.
But should the landlord have the right to appeal [an assessment, for
instance] if the tenant does not want an appeal? The landlord may
have a legitimate concern near the end of the lease term. If so, any
increases in taxes resulting from her ill-advised appeal should be paid
by the landlord [or deducted from the ground rent]. If her appeal is
successful, at least her expenses should be reimbursed, up to the net
benefit to the tenant.

§ 2:8.5 Governmental Landlords: Lease Excise Taxes

Real property owned by governmental entities is often exempt from
local real property taxes. When government-owned land is leased to
private parties, some states have imposed leasehold excise taxes as
rough equivalents to general property taxes, so that the government
lessee is not given an advantage over private competitors [and, of
course, so that property tax revenues are maximized].\(^{118}\) The taxation
of the improvements constructed by the tenant/developer may vary
considerably, as well as taxes attributable to the land value or rental
paid.\(^ {119}\) Other states apply their general property tax laws to the non-
governmental lessee.\(^ {120}\)

In some jurisdictions, there are laws providing for payments by the
tenant in lieu of taxes that permit the governmental agency leasing the
land to provide favorable payment terms to the tenant/developer as an
incentive to undertake desired development.\(^ {121}\)

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118. See, e.g., ARIZ. REV. STAT. §§ 15-971, 15-636, 42-163, 42-1901 through
119. See, e.g., WASH. REV. CODE § 82.29A.030. For a consideration of related
issues, see Clark, The Government Lease Excise Tax: Challenging the
Excise-Property Tax Distinction, 29 ARIZ. ST. L.J. 871 (1997) [hereinafter
Clark].
120. Clark, supra note 119, at 873, n.11.
121. See Lee A. Kuntz, Am. C. Real Est. Law., Why Fee Owners Ground Lease
Their Properties 2 (Oct. 2005) [seminar article], available at www.acrel.org/
Documents/Seminars/2005%20Kuntz%20-%20Why%20fee%20owners%20
ground%20lease%20properties.pdf.