



# Ground lease interpretation — rent review and adjustment valuation issues

By Tony Sevelka

One of the most challenging and controversial areas of real estate appraisal involves the re-evaluation of land encumbered under long-term ground leases. Occasionally, the intent of the parties to the ground lease is not clearly evident from the language of the lease. Appraisers involved in arbitration and litigation are sometimes called upon to estimate or determine the value of land as the basis of adjusting rent pursuant to the provisions of an existing ground lease when the landlord and tenant are unable to reach agreement on the interpretation of the ground lease and the value of the land.



## Ground lease agreement

A ground lease agreement is an alternative to outright disposition of land. Leasing provides a mechanism whereby a property owner can receive periodic revenue in the form of ground rent without relinquishing ownership, and a tenant can preserve development capital for construction of improvements while enjoying long-term use of land for development purposes. Rental payments are usually net and similar to an annuity, providing the landlord with a carefree investment. Obligations for the construction and financing of improvements and day-to-day management of any proposed development throughout the term of the lease remain the sole responsibility of the tenant.

The lease arrangement is usually long-term so as to ensure that the tenant's intended use and investment of development capital are capable of being profitably amortized over the term of the lease. Sometimes, the provisions of the lease restrict the tenant's use of the land. The tenant may also be obligated to maintain a constructed building to a certain standard throughout the term of the lease. The owner has priority over any construction financing that the tenant may require, unless the owner is prepared to postpone or subordinate its interest in favour of the lender, and any future liens registered against the property. At the end of the lease term, the property is returned to the owner, with any existing structures on the land forming part of the owner's reversionary interest in the land. Because of the long-term nature of a ground lease, it is not uncommon for the lease to include a provision for the rent to be adjusted periodically throughout the term of the lease based on the value of the land.

## Re-evaluation of land value

Whenever a ground lease calls for periodic review and adjustment of the rent throughout the term of the lease or any renewal option period, the determination of rent is usually predicated on the value of the land. However, the land valuation clause is often in dispute and subject to more than one plausible interpretation.

At the centre of the dispute is the question of whether the lease and its subsisting terms are to be ignored and the land valued as a fee simple estate or if the lease is to be considered in its entirety and the land valued only for the remaining term of the lease, ignoring the owner's reversionary interest in the property. There are a number of equally important issues between these two polarized valuation positions that may have to be considered in the determination of land value under the valuation clause.

## Concept of land value and income value equivalency

A land valuation clause in a ground lease that requires the land (site) to be valued as if unencumbered by the lease (freehold) is a significantly less difficult exercise than trying to establish the value of the site having to take into account the remaining term of the lease. A site held in perpetuity as a freehold interest is more valuable than the same site held for a fixed term under lease.

On the assumption that the market value of a site has an equivalent income value, the value of a site for any particular holding period can be established. Starting with a basic premise that the present value (P.V.) of \$1.00 per annum (p.a.) in perpetuity capitalized (discounted) at an assumed market rate of return of 8.0% p.a. is worth \$12.50 ( $\$1.00 \div 0.08 = \$12.50$ ), the income value for other holding periods can be illustrated.<sup>1</sup>

P.V. of \$1.00 p.a. for 10 yrs. discounted @ 8.0% =	\$ 6.710081
P.V. of \$1.00 p.a. for 20 yrs. discounted @ 8.0% =	\$ 9.818147
P.V. of \$1.00 p.a. for 30 yrs. discounted @ 8.0% =	\$ 11.25778
P.V. of \$1.00 p.a. for 40 yrs. discounted @ 8.0% =	\$ 11.92461
P.V. of \$1.00 p.a. for 50 yrs. discounted @ 8.0% =	\$ 12.23349
P.V. of \$1.00 p.a. for 60 yrs. discounted @ 8.0% =	\$ 12.376552
<b>P.V. of \$1.00 p.a. in perpetuity @ 8.0% =</b>	<b>\$ 12.50</b>

The P.V. of \$1.00 p.a. increases with the length of the holding period. A holding of 10 years is equal to 53.681% of the value of the holding in perpetuity ( $\$6.710081 \div \$12.50 = 0.536807$ ), whereas a holding of 60 years is equal to 99.012% ( $\$12.376552 \div \$12.50 = 0.990124$ ) of the value of the holding in perpetuity at an 8.0% discount rate.

If the market value of a particular site is shown to have a freehold value (value in perpetuity) of \$1,000,000, the value of the same site held for a fixed term of (say) 20 years will be less. At an interest rate of 8.0%, the P.V. of \$1.00 p.a. in perpetuity is \$12.50, compared to a P.V. of \$9.818147 for 20 years. The P.V. of \$9.818147 for 20 years compared to the P.V. of \$12.50 in perpetuity expressed as a ratio is 0.785452 ( $9.818147 \div 12.50 = 0.785452$ ), or 78.545%. Applying the income value ratio of 0.785452 or 78.545% to a \$1,000,000 freehold site value indicates a value of \$785,450 for the site as a 20-year holding. Therefore, an 8.0% return will generate \$80,000 p.a. on a freehold value of \$1,000,000 compared to \$62,836 p.a. for the 20-year holding value of \$785,450.

By this approach, the value of the freehold interest is diminished by \$168,517, which is the P.V. of the annual rental loss of \$17,164 discounted at 8.0% for 20 years, the assumed remaining term of the lease. However, any tenant improvements or structures of value that are to revert to the owner upon expiry of the lease could possibly offset any diminution in the freehold value of the site due to the remaining term of the lease.

## Rental calculation

Applying the *concept of land value and income value equivalency* illustrated in the preceding section, the annual rental would be fixed at \$62,836 p.a. for 20 years. If the ground lease calls for a rate of return other than the assumed market rate (8.0% in the previous example), the ground rent calculation would require further modification.

Assuming that the land valuation clause in a ground lease calls for an annual rental to be fixed at say 6.0% of the market value of the site, two outcomes are possible: with a freehold site value of \$1,000,000, the annual rental at 6.0% would be fixed at \$60,000; conversely, if the site were valued as a 20-year holding, taking into consideration only the remaining term of the lease, the annual rental would be fixed at \$47,127 ( $\$785,450 \times 0.06 = \$47,127$ ). It should be noted that the annual rental payment of \$47,127 for a 20-year holding is also equivalent to 78.545% of the annual freehold rental of \$60,000 ( $\$47,127 \div \$60,000 = 0.78545$ ).

In this illustration, the owner would receive \$12,873 more in annual rent during the term of the lease if the site were valued as a freehold interest compared to the value of the site as a 20-year holding applying the *concept of land value and income value equivalency*.

## Land valuation issues

The issues in a ground lease that must be addressed by an appraiser when estimating land value for the purpose of fixing the rental as part of the rent review or lease renewal process are listed as follows:



- Whether the land should be valued as a fee simple (freehold) estate or for a term consistent with the remaining lease term.
- Whether the lease should be ignored.
- Whether the subsisting terms of the lease prevail during a rent review or renewal option.
- Whether the remaining term of the lease and any renewal option period should be considered in establishing highest and best use.
- Whether only the use(s) permitted by the lease or alternative uses can be considered.
- Whether the existing building envelope exceeds the permitted density or is underdeveloped with excess air rights available, and whether either scenario should be considered in the value of the land.

Appraisers, arbitrators and the courts have wrestled with these ground lease issues, producing mixed results based on their respective interpretations of a particular ground lease and whether the lease should be ignored or linked partially or totally to the land valuation process. Some view the land valuation clause as instructive of the land valuation process in isolation of the remaining lease document, arguing that the value of the land, absent of any unequivocal language to the contrary, must be based on its highest and best use as a fee simple estate. Those that view the ground lease as controlling the valuation process argue that the lease provisions, including the remaining term of the lease, must be considered on the basis that the tenant is restricted by the lease from realizing the highest and best use of the property.<sup>2</sup> It is this circular reasoning in the valuation process that remains unresolved. Nonetheless, a number of court decisions have interpreted land valuation clauses that include phrases such as “bare land,” “unimproved” and “vacant and unimproved” as meaning to exclude not only improvements but encumbrances as well.<sup>3</sup>

A number of ground lease cases dealing with the re-evaluation of land and the numerous issues involved in the interpretation of the land valuation clauses have been examined and reviewed in this article. The cases are intended to provide the appraiser/arbitrator with a better understanding of the issues that must be explored before estimating or determining the value of land as a basis for adjustment of rent pursuant to the provisions a ground lease.

As long as the objective of a valuation is to estimate market value (or apply market value concepts), whether as a fee simple estate (freehold) or for the remaining term of a lease (ignoring the reversionary interest), in its highest and best use or under a restricted highest and best use (use restrictions under lease<sup>4</sup>), it is not the role of the appraiser or arbitrator to ensure that the land value estimate is equitable to both the landlord and tenant.

## Ground lease cases

The ground lease cases presented only address leases that required a determination of land value as opposed to a determination of rent.<sup>5</sup> Where the objective is to estimate land value and the lease dictates the interest rate (rate of return) to be applied, the calculation of rental becomes a mechanical exercise once the value of the land has been established.

**Lease No. 1 – *Urban Equities, Inc. v. Mardordic Realty Co., Inc.***<sup>6</sup> The original term of the lease commenced April 1, 1937 and terminated March 31, 1958. The original 1937 lease provided that,

*the said premises are now in the possession of the lessors, free from all restrictions arising from the grant that would operate to prevent*

*the erection and operation of the garage hereinafter mentioned... And it is agreed that the premises hereby demised shall be used and occupied... as a place for the construction, operation and maintenance of an Automobile Garage, Salesroom and Repair Shop, or for any other ordinary business, without the consent of the Lessor, provided that said premises may not be used for any business in the nature of a nuisance; nor will it permit or suffer them to be so used.*

*A modification of the lease on May 6, 1947 provided for two renewal periods at the option of the tenant: the first for an additional 21 years commencing April 1, 1958; the second for a period of 21 years commencing April 1, 1979. The May 6, 1947 amendment allowed the tenant to alter or demolish existing buildings and erect a new building subject to prior approval of the plans and specifications by the lessor, which provided a covenant not to unreasonably withhold approval of the plans and specifications if they provide for a building or buildings of a character of construction equal to the building now erected on the premises.*

The only issue submitted for determination by the New York Supreme Court was whether the language in the lease legally restricted the use of the premises to related automotive purposes. The court construed the language in the demising clause as a guarantee or warranty against any restriction from the grant that would prevent the erection and operation of the garage by the tenant. The *use* clause was considered descriptive of the intended use of the demised premises only, as the lease expressly provided, in addition to the operation of a garage for “any other ordinary business.”

During the first renewal term, the valuation formula for the fixing of the annual rental was to be a sum equal to six per cent of the fair market value of the land determined by appraisal as hereinafter provided by the majority opinion of the Appeals court:

*[T]he appraisal of the fair market value of the land demised, for the purpose of establishing the annual rental for the renewal period commencing April 1, 1958, shall be made on the basis of the best use to which the land can be put and not limited to improvement as a garage, consideration, however, to be given to the term and renewal options affecting the land provided for and contained in said lease and modification thereof...*

The majority opinion of the New York Supreme Court, ruling that it was within its jurisdiction to do so, went beyond the only question it was asked to decide by holding that,

*consideration should be given to the term of the lease and the renewal options therein in determining the use to which the land can be put... The only limitation upon value, if any, is the number of years the most advantageous use of the land can be enjoyed under the lease.*

In the minority dissenting opinion, the argument was advanced that,

*the majority was instructing the appraisers to take into consideration the economic fact that the premises are encumbered by a renewed lease for a 21-year term, with a further right of renewal for 21 years. In this respect, there is not only being decided more than the disputed legal question submitted, but the appraisers may be placed in a difficult, if not impossible, position... Most disturbing, however, is the fact that majority's view may have created a dispute where none, so far as is known, existed before... The parties... by their lease contract had agreed that the land value upon which the rental was to be based was to be determined by appraisers. The appraisers having disagreed with respect to whether the lease legally restricted the use of the premises, the court's determination has been sought on that sole question of law... Hence, for all that one may know, the appraisers*

may have already determined the effect of the most recently renewed lease, and the further right to renew, on the value of the land... [I]n determining the land value, to look to the lease term... may involve an appraiser in an inescapable circle of reasoning... The problem... is not avoided facilely by limiting the appraisers to looking merely to the term of the renewed lease and the further right of renewal – on the theory that the term may affect the economic, as distinguished from the legal, use to which the tenant may put the land.

#### Observations

- The majority opinion of the court decided that the value of the land should be based on any permitted use under the prevailing governmental land use controls.
- The majority opinion instructing the appraisers to consider the 21-year term and the 21-year renewal option might preclude some higher order uses from determination of the highest and best use, negatively impacting the value of the land.
- The market value of the land for a particular use held for 42 years, including the 21-year renewal option, would be less than the value of the land for the same use held in perpetuity as a fee simple estate.

#### Lease No. 2 – 185 Lexington Holding Corp. v. Aaron Holman, as Trustee<sup>7</sup>

Under the terms of the 21-year lease, the tenant was required to demolish the existing structure and construct another in its place when the ground lease was initially negotiated. Various restrictions limiting the use of the land to the replacement structure were imposed on the tenant such that:

- The building be maintained in good condition and repair.
- The building be erected with the landlord's approval.
- The structure be built to cover as much land as allowed by the local building department regulations.
- The structure is at least six stories in height.

Upon expiry of the lease term, the tenant exercised the first of two 21-year renewal options. In dispute was the interpretation of the lease clause relating to the fixing of rent. The lease called for the annual rent to be fixed for 21 years during the renewal term at the rate of "6% of the value of land only, without improvements."

The court decided that,

*[t]he express purpose of the landlord was to provide for rental based upon the value of the land only, which would not be subject to the acts of either party. It was intended to remove any other consideration from the determination of the rental to be fixed during the succeeding two 21-year renewal periods.*

In summary, the court interpreted the language as excluding consideration of the lease itself in establishing the value of the land. Although the tenant argued this interpretation of the lease, claiming "hardship of the contract," the court stated that "a poor bargain may not be made good by judicial construction or recasting of the contract."

#### Observations

- The phrase "without improvements" was considered synonymous with the phrase "vacant and unimproved."
- The value of the land "without improvements" could not take into account the existing lease, and the land was to be valued as a fee simple interest.
- The highest and best use of the property would be determined as if the property were unimproved and without taking into consideration the remaining term of the lease.
- There is no reference to market value in determining the "value of the land."

#### Lease No. 3 – Plaza Hotel Associates et. v. Wellington Associates, Inc.<sup>8</sup>

The ground lease pertains to the land under the Plaza Hotel, overlooking Central Park, in the City of New York. The Plaza Hotel is built on a plot of over 50,000 sf. near the prestigious 50-storey General Motors office building.<sup>9</sup>

On October 1, 1953, Hilton Hotel Corporation sold the Plaza Hotel to Park-59th Street Corporation. As part of the transaction, Hilton received an option, exercisable between October 1, 1965 and March 31, 1966, to repurchase an undivided one-half interest in the land only, for (1) \$400,000 and (2) an assumption of one-half the mortgage indebtedness and one-half the real estate taxes applicable to the land itself.

Upon exercise of the option, Hilton (or its assignee) would grant to the then owner of the other undivided one-half interest in the land a lease of Hilton's half interest in the land for a term of 20 years, extendable for an additional 30 years at the lessee's option. If, however, the property was no longer used primarily for hotel purposes at the time of Hilton's option, Hilton (or its assignee) was not required to enter into such a lease and was to have all the rights of a tenant in common of the land. Annexed to the October 1, 1954 option agreement was the form of the lease to be executed in the event that the option was exercised. An Article of the lease form provided that,

*Lessee shall pay as rent for the interest in the land hereby demised an annual ground rental equal to 3% of the value of all of the land (wherever permitted by the context the word 'land' as herein used is intended to mean the land only, exclusive of the buildings and improvements thereon) as of the date of the commencement of the term of this lease.*

Another Article of the lease provided that the Lessee had the right to alter, reconstruct, and demolish any and all buildings and improvements and erect new buildings,

*provided that if any such renovation, reconstruction, demolition or new building or structure is designed to be used primarily for purposes other than hotel purposes, the prior written consent of the Lessee [sic-should read Lessor] shall be required.*

*The Article dealing with termination of the lease provided that, if at any time the land and buildings and improvements thereon shall cease to be used primarily for hotel purposes, the Lessor shall have the right to terminate this lease by written notice given... within six months from the date of the cessation of such use.*

At the time of the rental dispute to fix the annual rental payment for the first renewal term of 20 years from October 1, 1965, Plaza Hotel Associates owned the building, and Wellington Associates, Inc owned the underlying land.

As the parties were unable to agree as to the value of the land for the purpose of determining the annual rental to be paid, the matter was submitted to appraisers in accordance with lease provisions. The three appraisers valued the land without regard to the limitations on use contained in the lease. All three appraisers valued the land in its highest and best use for an office building, even though a provision of the lease required the Lessor's approval for the construction of a new building designed "primarily for purposes other than hotel purposes." The Supreme Court of New York declared the appraisals invalid ruling that,

*in valuing the land as if it were available for the highest and best use, free from the restrictions of the lease, the appraisers violated the provisions...of the lease which did not authorize such an appraisal.*



The Lessor's appeal of the ruling was denied, and the majority opinion of the Appeals Court upheld the ruling of the lower court that the lease had to be considered requiring the land to be appraised as a hotel site.

The minority and dissenting opinion of the Appeals Court provided its review of the appraisals and the lease restrictions, noting that,

*absent a manifestation of contrary intent it is presumed that land is valued subject to the existing restrictions upon its use. This proposition is indisputable where the restrictions are extrinsic to the lease itself... [i.e., zoning, easements, and restrictive covenants registered against title]. There is less reason for assuming, however, that parties intended the restrictions of the lease itself to be considered in fixing value; for such restrictions are not pre-existing or beyond the control of the parties. Moreover, the fact that the lease rent is determined by the appraisal valuation inevitably has some circular effect. It is equally logical to consider the land that is valued as being, on the one hand, unencumbered or, on the other, restricted by the lease itself. The circle may be broken at either point, depending upon the assumption as to the sequence in which the use restrictions should be considered, before or after the lease takes or is given effect. In such cases, there must be reference to the language of the documents and, because of the ambiguity, to the business realities and underlying events of the transaction to determine the actual expressed intention of the parties.*

The minority and dissenting opinion also alluded to other language in the lease that provided for the division of rents and profits or proceeds in the event of a tenancy in common relating to the burden of any existing mortgage encumbrance, possibly inferring that the valuation should discount the use restrictions. However, the absence of the same or parallel language in the valuation clause was considered hardly conclusive of the majority opinion.

#### Observations

- The use provisions of the existing lease could not be ignored and the land had to be appraised as if it were a "hotel" site.
- The valuation clause "value of the land" excluded from consideration only the improvements but not the encumbering lease.
- Pre-existing encumbrances such as easements and rights-of-way and restrictive covenants that run with the land are distinguishable from the lease and should be considered in the valuation of the land.
- The land had to be appraised under a restricted "hotel" use, not in its highest and best use as "office."
- The decision is not clear as to whether the land for "hotel" use is to be appraised as a fee simple interest or as a leased fee interest taking into account the remaining term of the lease, including the 30-year renewal option.
- There is no reference to *market value* in determining the "value of the land."

#### Lease No. 4 – *New York Overnight Partners v. Joan Gordon*<sup>10</sup>

The lease pertains to the land under the Ritz-Carlton Hotel at 112 Central Park South, New York City. The ground lease was executed in 1963. The lease provided for an initial term of 30 years with an annual rental of \$78,000, and four 15-year renewal options with the annual rental fixed at 6.5% of "the appraised value of the land."

Further, the lease provided, in part,

*[t]hat each extended term shall be upon the same terms, covenants and conditions as in this lease provided, except... [for] the net annual basic rental for each fifteen (15) year extended term...*

At issue in this lease was the meaning of the term "appraised value of the land." The tenant appealed that part of the ruling of the Appellate Court which held that,

*the appraiser must determine the value of the land as though vacant, without improvements, and subject to current zoning regulations*

The meaning of "appraised value of the land" was critical for establishing the rental amount for the first 15-year renewal term. The lease defined the subject "land" as,

*[a]ll that certain plot, piece or parcel of land, without the buildings and improvements thereon erected...*

It was the position of the tenant that the appraiser should consider the "benefit" any improvement "imparts" to the land, even if that improvement (building envelope) constitutes a legally non-conforming use. As built, the existing hotel structure had a gross floor area of about 152,000 sf. Under the then prevailing governmental land use controls, a building envelope of only about 82,500 sf. would be permitted. A review of the Appellate Court's ruling indicated that the,

*clear and unambiguous terms of the Lease [provide]... that the 'appraised value of the land' may be determined only by reference to the raw land... exclusive of the building and all 'improvements.'*

While land should be appraised for the best, most advantageous use, the court opined that in this case,

*the land's fair market value must be determined by the terms of the lease, taking into account any restrictions or encumbrances affecting the land.*

On this basis, the court instructed the appraiser to determine the value of the land as if vacant and unimproved, subject to current zoning restrictions and contractual limitations, and to consider the effect of the lease on the value of the land. Because of the express terms in the lease, the Appeals Court ruled the parties did not intend the land to be appraised for its highest and best use to establish the rental for the renewal term.

#### Observations

- The lease term "appraised value of the land" was determined to mean "raw land" exclusive of the building and all improvements.
- The existing building envelope, which was larger than permitted under the prevailing zoning by-law, could not be considered in estimating the value of the land (i.e., surplus density to be ignored).
- The determination of highest and best use was to be a restricted one implying that the subsisting terms of the lease, including the remaining term of the lease, would have to be taken into account.
- There is no reference to *market value* in determining the "appraised value of the land."

#### Lease No. 5 – *Olympia & York 2 Broadway v. Produce Exchange Realty*<sup>11</sup>

The land at 2 Broadway Avenue, an office complex in Manhattan, New York, was leased in 1956. An amendment to the lease provided for a term of 50 years with a fixed rental for the first 25 years, with the rental for the remaining 25 years commencing 1981 to be determined as provided for in the amended lease. Failing agreement of the parties to fix the rent,

*[t]he rental was to be a sum equal to 5% of the value of the land, as determined by appraisal, the land to be considered as vacant and unimproved.*

In accordance with lease provisions, three appraisers were appointed, the landlord and tenant each selected one appraiser,

with the third appraiser appointed by the two appraisers selected by the parties. The decision on value concurred to by any two of the appraisers would be final and binding on the parties. Each appraiser developed his or her own value estimate and eventually two appraisers concurred with a land value estimate of \$40,200,000.

An appeal of the appraisers/arbitrators' award was allowed as the court ruled that,

*the case presents triable issues of fact and law, including, but not limited to the consideration, if any, to be given to the lease as an encumbrance on the property and the alleged refusal of the appraisers to permit...[the tenant] to examine...[one appraisal] report, which cannot be determined on the basis of the affidavits and exhibits submitted.*

The New York Supreme Court dismissed the appeal on the grounds that there were no triable issues, reasoning as follows:

*The lease specifically provided for a determination of rental based upon value – a sum equal to 5% 'of the value of the land (said land to be considered as vacant and unimproved), as fixed and determined by appraisal, under the provisions...of the Lease.' By thus specifically providing that the value of the land was to be considered as vacant and unimproved, the parties manifested a clear intention that existing structures, encumbrances and leases not be taken into account in fixing value.*

The New York Supreme Court also observed that the tenant was enjoying the highest and best use of the property, in contradiction to the lower court's view that,

*after noting the property was being used at its highest and best use as a commercial office structure,...concluded that the long-term lease reduced its value since the property was not, by reason of the lease, being put to its highest and best use.*

#### Observations

- The phrase "vacant and unimproved" was taken to mean that in valuing the land all of the existing improvements and existing encumbrances and leases were to be ignored, and the land valued as a fee simple interest.
- The value of the land was to be based on its highest and best use for an office structure even though the tenant had only 25 years remaining on the lease, an inadequate period over which to make office use financially feasible.
- There is no reference to *market value* in determining the value of the land as if "vacant and unimproved."

#### Lease No. 6 – No. 100 Sail View Ventures Ltd. v. Janwest Equities Ltd.<sup>12</sup>

The Agreement that provided for the leasing of the land at 625 Howe Street, in Vancouver, British Columbia, was entered into on February 20, 1981. The lease term was for a period of 50 years with an option to renew for a further term of 25 years. The lease called for the payment of (minimum) base rent in a specified amount but provided for the base rent to be renegotiated and adjusted every five years during the last 40 years of the lease term. The rental adjustment clause reads as follows:

*On or before the end of the tenth year of the term, the Base Rent payable shall be renegotiated to a value equal to 10% of the fair market value of the Leased Premises as bare land at the date of the review...*

Other provisions in the lease stipulate that the tenant may use the premises,

*only for the purpose of a Hotel and related hospitality business... [and] the base rent is the minimum rent to be paid by the Tenant and*

*there is also percentage rent payable in an amount equal to 15% of the gross room revenue generated by the hotel on the leased premises.*

The question of law before the British Columbia Supreme Court<sup>13</sup> was,

*whether the valuation of the leased premises should be made on the basis that the land may only be utilized as a hotel or the basis that the land may be utilized for any purpose. In other words, the question is whether the valuation should take into consideration the existence of s. 6.02 of the lease limiting the use of the land to a hotel and related hospitality businesses.*

The British Columbia Supreme Court ruled in favour of the tenant that the valuation of the land should be made on the basis that it may only be utilized as a hotel for the following reasons:

*[T]he draftsman of the Lease was intending to convey in using the phrase 'bare land'... that the property was to be valued as if it did not have a building constructed on it. I agree with the Court in United Equities that, if the parties had intended the valuation to be conducted without consideration of the restriction in the Lease regarding the use of the property or any other provisions contained in the Lease, they would have stated it expressly. It was necessary for the draftsman to include the phrase 'bare land' because a building was going to be situated on and forming part of the land and if the phrase was not included, the rent would be determined on the basis of the value of the improved land and this would not be appropriate for a ground lease. I do not believe that the draftsman had any other purpose in mind when he or she inserted the phrase... The rent being established pursuant to s. 4.02 of the Lease is the base rent or, in other words, the minimum rent to be paid by the tenant. The actual rent is the percentage rent that is equal to 15% of the revenues derived from renting the rooms in the hotel. If the percentage rent is determined on the basis that the property is used as a hotel, it follows that the base rent should be determined on the same basis unless the parties expressly state that it is to be determined on some other basis.*

Reflecting on its judgement, the B.C. Supreme Court stated that,

*fairness should not enter into the decision...[for] it is a question of interpretation of the lease and the correct interpretation should prevail even if the result may not seem fair to one of the parties.*

On appeal, the judgement of the B.C. Supreme Court was set aside with the majority opinion of the Appeals Court ruling in favour of the landlord holding that the phrase "fair market value of the Leased Premises as bare land,"

*must be interpreted...as necessarily inferring that the valuation be done without reference to the lease and consequently without reference to the restricted use found in the lease...[I]f the parties intended to include as a factor in the valuation of base rent the restricted use they would have expressly said so in words that would have modified the words 'bare land'...[T]o factor in the lease or the restricted use in it would result in the landlord being denied the fair market value of the land 'as bare land.'*

The Appeals Court concluded that the calculation of Base Rent, *was to be calculated on the basis of fair market value of the Leased Premises as bare land without taking into consideration the existence of the restriction in...the Lease as to use.*<sup>14</sup>

The minority and dissenting opinion of the Appeals Court, which agreed with the trial judge, stated:

*There was a ground lease in which the landlord imposed a restriction on use. I see no difference in law between a restriction on use imposed by the landlord and a restriction imposed on both the landlord and tenant by a zoning authority such as a municipality. In either case, the tenant is not free to use the improvement except in*

accordance with the restriction. I cannot think that parties intended that the base rent payable by the tenant should be calculated as though the restriction on use imposed by the landlord did not exist. Because of the restriction the highest and best use of the land was not available to the tenant through the 50 years of the term of the lease or the renewal period of 25 years. I see no reason to calculate the rent payable to the landlord on the basis of the highest and best use of the land when the landlord was responsible for the term in the lease foreclosing that use.

#### Observations

- The phrase “fair market value of the Leased Premises as bare land” was taken to mean a valuation of the land without improvements and without lease.
- Market value was to be based on the highest and best use of the land as if it were a fee simple interest.
- The “base rent” clause superceded the “percentage rent” clause, which alluded only to hotel use, as the foundation for determining the highest and best use of the land.
- The tenant will be obligated during the renewal term to pay a rent based on the highest and best use of the property while restricted to “hotel” use.

#### Lease No. 7 – *Ruth v. S.Z.E. Corporation*<sup>15</sup>

This lease provided for an initial term of 20 years and for two successive 20-year renewal terms. The provision for rent during the renewal period was to be 6% of the,

*full and fair value of the land demised which the same would sell for as one parcel considered as vacant and unimproved, in fee simple, by private contract, free of lease and unencumbered.*

The lease restricted the use of the property to its existing use as a two-storey store and showroom building. At the time the rent was to be fixed during the first renewal period, the parties could not agree as to whether the use provision contained within the lease should be considered in valuing the land. The parties took their dispute to the New York Supreme Court, Special Term, which characterized the issue in the following manner:

*It is whether the arbitrators in determining the value of the property on which the rent for the first renewal term is to be based may take into account its restricted use under the provisions of the underlying lease. The...[lessee] argues that the lease provisions obligating it to maintain the existing buildings, as constructed and altered by its predecessor in interest, in good repair and forbidding it to make any alterations or changes costing more than \$5,000 without the lessor's written consent, limit the possible use of the demised premises to the operation of these very buildings. It urges that this restriction on use necessarily affects the value of the land and is an element properly to be considered by the arbitrators in determining its value under the lease formula. The...[lessors] insist, to the contrary, that the clear and explicit language of the formula forbids consideration by the arbitrators of this restricted use as an element of the value of the land.*

In finding that the arbitrators were not to consider as an element of value the restrictions on use contained within the lease the court stated that the lessee,

*argues that the words 'free of lease' were intended to exclude from the value of the vacant land any enhancement from the existence of a long-term lease yielding an assured income. It seems self-evident that, by like reasoning, the depressing effect of a lease with a low or inadequate rent would equally have to be disregarded. If the phrase 'free of lease' is given its plain and natural meaning, the lease in its entirety must be eliminated from consideration, whether its provi-*

*sions spell good or ill fortune for one party or the other. The restriction on use, which, according to the...[lessee's] contention, impairs the value of the land, if imposed at all, is imposed solely by the underlying lease. The broad question whether a restrictive covenant in a deed or like instrument, affecting the value of the land, may be considered is not before the court. The precise question is whether the asserted limitation on use, created by the lease before the court may be taken into account in applying a formula which prescribes that the land is to be valued "free of lease." In my opinion, it would be repugnant to the language employed to hold that the limitation on use springing exclusively from the lease itself may be treated by the arbitrators as an element of value. Whatever else the parties may have had in mind, it is inconceivable that when they declared explicitly that the land be valued 'free of lease,' they intended that the arbitrators might give heed to the very lease which so declared. Such a ruling would delete the phrase 'free of lease' from the formula.*

#### Observations

- The phrase “full and fair value of the land...considered as vacant and unimproved, in fee simple...free of lease and unencumbered” is unequivocal in its intent that the land be valued as a fee simple interest without improvements and without the lease.
- The land was to be valued in its highest and best use without regard to the remaining term of the lease.
- The tenant would have to pay a rent based on the highest and best use of the land while being obligated to maintain the existing structure.
- There is no reference to *market value* in the valuation clause requiring the “full and fair value of the land.”

### Possible land valuation scenarios

The interpretation of the land valuation clause when the ground lease calls for a rent review during the term of the lease or when a renewal option is exercised can have a profound impact on determination of the quantum of annual rental. As noted from the review of a number of ground leases, a dizzying array of interpretations of the land valuation clause are possible.

Where the language of the land valuation clause does not explicitly exclude consideration of the lease, the fundamental issue is whether the lease itself is simply instructive as to the manner in which land value is to be determined as a fee simple interest or if the subsisting terms of the lease must be considered in determining land value as a holding corresponding to the remaining term of the lease.

Summarizing the various court rulings on the ground leases analyzed, there are essentially four possible outcomes in dealing with the valuation of the land at the time of rent review or renewal:

- 1) The land is valued in its highest and best use as a fee simple interest, on the assumption that the land is unimproved and unencumbered by the lease.  
A valuation under this premise is straight forward, with the analysis of highest and best use based on an assessment of those uses that are legally permissible, physically possible, financially feasible and maximally productive, and that result in the highest net present land value estimates for the subject property.
- 2) The land is valued in its restricted highest and best use over the remaining term of the lease, on the assumption that the land is unimproved and the use clause in the lease is superceded.



A valuation under this premise must consider only those uses legally permissible and physically possible that are financially feasible and maximally productive over the remaining term of the lease. As an example, if the remaining term of a lease at the time of rent review is only 20 years, legally permissible and physically possible high order uses such as office buildings, hotels and shopping centres would not be financially feasible, and would be precluded from the restricted highest and best use analysis.

Once the restricted highest and best use has been established for the subject property, comparable land sales of a similar use, if fee simple (freehold) acquisitions, can not be applied directly to establish the value of the subject property as a 20-year holding under lease.

One way to handle the adjustment or conversion from freehold to the term of the lease is to treat the freehold value of the land as a holding in perpetuity, and then convert it to a value for the appropriate holding period consistent with remaining lease term.<sup>16</sup> See sample calculations under *concept of land value and income value equivalency*.

- 3) The land is valued on the use or uses prescribed by the lease over the remaining term of the lease, on the assumption that the land is unimproved.

A valuation under this premise is based on comparable land sales that reflect only the use or uses permitted under the lease. If the comparable land sales are freehold acquisitions, they will have to be adjusted to their equivalent value reflecting the remaining term of the lease. The adjustment process can be handled in the same manner as illustrated under the preceding premise.

- 4) The land is valued on the use or uses prescribed by the lease as a fee simple interest, on the assumption that the land is unimproved and the remaining term of the lease is ignored. A valuation under this premise is based on comparable land sales that reflect only the use or uses permitted under the lease while ignoring the remaining lease term and valuing the land as a freehold interest.

## Conclusion

Because of the many complex issues involved in the valuation process, the appraiser must undertake a thorough reading and review of the ground lease to understand the potential linkages between the lease and the land valuation clause contained therein.

Where interpretation of the valuation clause in the ground lease is in doubt and the dispute is to be resolved either by arbitration or court, it is advisable for the appraiser to prepare land value estimates based on a number of alternative positions. Advancing only one valuation premise exposes the client to the potential risk of having no appraisal evidence should the arbitrator or the court reject the single-valuation premise.

Absent any jurisdictional exception, a valuation prepared in contemplation of judicial or quasi-judicial proceedings must be prepared in compliance with the *Uniform Standards of Professional Appraisal Practice (USPAP)*<sup>17</sup>, standards that govern the appraisal profession in North America. Hypothetical and extraordinary appraisal assumptions required for legal purposes must be explicit and prominently noted in the appraisal report. ♦

## End notes

1. A higher interest rate will reduce the length of the holding period approaching perpetuity. Conversely, a lower interest rate will increase the length of the holding period approaching perpetuity.
2. When the annual rental is to be adjusted, if the remaining term is only 20 years and the use(s) to which the property can be put is restricted by the lease, the economic hardship on the tenant would be profound if the land value were to be based on highest and best use as a fee simple interest.
3. See *No. 100 Sail View Ventures Ltd. v. Janwest Equities Ltd.*, (1993) B. C. J. No. 2338 (Q.L.) (B.C.C.A.); *Standard Life Assurance Co. v Parc-IX Ltd.*, 3 O.R. (3d) 782 (1991) O. J. No. 1106 (Q. L.); *Olympia & York 2 Broadway*, (1983) 462 N.Y.S.2d 456, 93 A.D.2d 465 (NY-QL 1843); *185 Lexington Holding Corp. v. Aaron Holman, as Trustee* (1959) 189 N.Y.S.2d 269, 19 Misc. 2d 521 (NY-Q.L. 1644)
4. When the lease permits only one use, the indication of land value is "use value", defined as *the value a specific property has for a specific use*.
5. Tony Sevelka, Part II of II: Rental dispute arbitration, *The Canadian Appraiser* (Fall 1998): 29-34. The author presents a two-step approach to the fixing of land rent when the valuation clause makes reference or points only to "market rent," requiring estimates of both the land value and the rate of return on the land.
6. *United Equities, Inc., v. Mardordic Realty Co., Inc.*, 187 N.Y.S. 2d 714, 8 A.D. 2d 398 [1959] (NY-QL 1629)
7. *185 Lexington Holding Corp v. Aaron Holman, as Trustee* 189 N.Y.S. 2d 269, 19 Misc. 2d 521 [1959] (NY-QL 1644).
8. *Plaza Hotel Associates v. Wellington Associates, Inc.*, 239 N.E. 2d 736, 22 N.Y. 2d 846 [1968] (NY-QL 1221).
9. Harry K. Weiss, "Valuation of Land Under Long Term Leases," *The Appraisal Journal* (October 1971): 520-525.
10. *New York Overnight Partners v. Joan Gordon*, 673 N.E. 2d 123, 88 N.Y. 2d 716 [1966] (NY-QL 14948).
11. *Olympia & Your 2 Broadway v. Produce Exchange Realty*, 462 N.Y.S. 2d 456, 93 A.D. 2d 465 [1983] (NY-QL 1843).
12. *No. 100 Sail View Ventures Ltd. v. Janwest Equities Ltd.*, [1993] B.C.J. No. 2338 (QL) (B.C.C.A.).
13. *No. 100 Sail View Ventures Ltd. v. Janwest Equities Ltd.*, [1992] B.C.J. No. 2286 (QL) (B.C.S.C.).
14. Application for leave to appeal to the Supreme Court of Canada was denied. *No. 100 Sail View Ventures Ltd. V. Janwest Equities Ltd.*, [1994] S.C.C.A. No. 40 (QL).
15. *Ruth v. S.Z.E. Corporation*, 153 N.Y.S. 2d 163 (Sup. Ct. 1956).
16. Tony Sevelka, "Alternative Valuation Methods for Leasehold Properties," *The Real Estate Appraiser and Analyst* (Spring 1986): 43-47.
17. USPAP are standards developed by the Appraisal Standards Board (ASB) of The Appraisal Foundation in the United States, which govern the recognized appraisal bodies in North America including the (U.S.) Appraisal Institute and the Appraisal Institute of Canada. Effective January 1, 2001, the Appraisal Institute of Canada adopted its own version of USPAP, known as the *Canadian Appraisal Standards*

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