

Ground lease rental disputes

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Introduction

Long-term ground leases typically include provisions for periodic rent reviews during the term of the lease that allow for the rent to be adjusted to reflect prevailing market conditions. A rent review clause in a ground lease that requires an estimate of fair market rent is distinguishable from one that calls for an estimate of fair market value of the land as part of a formula for computing rent. The latter involves a two-step approach that links an appropriate interest rate or rate of return, either market-derived or as prescribed in the ground lease, that is applied to the fair market value of the land in fixing the rent during the renewal period. An analysis of the following cases highlights the distinction between fair market rent and fair market value as applied in determining rent in a rent review dispute.

Fair market rent and fair market value

In the rental dispute between *B.C. Rail Partnership (lessor)* and *Pacific West Systems Supply Ltd. (lessee)*,¹ the ground lease dated March 12, 1972, as amended, includes a provision for reviewing the rent at five-year intervals. The rent in dispute for the five-year period from September 1, 1999 to August 31, 2004 was to be adjusted in accordance with the following clause in the ground lease:

The rental rate for the premises (excluding the lessee's buildings and fixtures) shall be subject to review and adjustment on notice by the lessor effective the 1st day of September, 1994, and thereafter at the end of each successive five-year period that the lease shall remain in effect. Provided, however, that the revised rental shall reflect a fair market rental on the date of such adjustment and in the event of disagreement will be settled by arbitration under the provisions of the *Arbitration Act* of British Columbia in force at the time of such disagreement.

In respect of the meaning of fair market rental, both parties were in agreement that the following were the leading cases in British Columbia:

1) *No. 100 Sail View Ventures v. Janwest Equities Ltd.*²

In a split decision, the appeals court ruled in favour of the landlord (Janwest Equities Ltd.). The court found that the phrase *fair market value of the leased premises as bare land* inferred that the valuation should be done without reference to the lease and consequently without reference to the restricted use clause in the lease, which stated that,

[t]he tenant shall use the leased premises only for the purpose of a hotel and related hospitality business including without limitation, parking, restaurants, health clubs, offices and retail outlets and not for any other purpose or business.³ As prescribed by the lease, the base rent was fixed at a value equal to 10% of the fair market value of the leased premises as bare land at the date of the review...[and] not be less than \$550,000 in any one year.

2) *Musqueam Indian Band v. Glass*

In a split decision, the Supreme Court of Canada addressing the definition of *current land value* in a rental review clause dealing with aboriginal reserve land in the City of Vancouver, in use as unserviced residential lots in a subdivision, ruled that,

[t]he parties intended that 'current land value' be interpreted and guided by what the land in fact is, namely a leasehold interest in reserve land. This interpretation reflects an intention that the value of the lease should follow the contemporary market for long-term leases of Indian reserve land.⁴ In computing the rent, the lease states...[a]n annual clear total rental which represents six percent (6%) of the current land value...shall be regarded as a 'fair rent.'

Pacific West Systems Supply Limited appealed an arbitrator's award claiming that the arbitrator made an error of law in refusing to consider restrictions on the use of the land contained in the lease in determining the fair market rental. It is submitted that this error led him to base his award on a percentage of the fair market value of the land, as





bare land, rather than the value of the land taking into account the restrictions on use in the lease. Specifically, the petitioner is restricted to using the lands for construction of a building supply business only.

The appeals court judge, commenting as follows, was satisfied that the appeal from the arbitrator's award had sufficient substance warranting it proceeding.

There is an argument, which appears to have merit, that the law in British Columbia is unsettled as to whether restrictions on the uses to which the land can be put should be taken into account in calculating the 'fair market rental,' in the absence of either a clause specifically linking the rental to the value of the land, or stating that the limitations in the lease should be taken into account. If the court, on appeal, determined that the limitations on the use should be taken into account, that might well affect the decision of the arbitrator, in view of his specific finding that such limitations should not be taken into account.

The use clause in the lease between *B.C. Rail Partnership (lessor)* and *Pacific West Systems Supply Ltd. (lessee)* contains a restriction that limits use of the property to 'construction and operation of a building supply business.'

While in agreement as to the fair market value of the bare land at \$450,000 as of September 1, 1999, both parties could not agree on the fair market rental.⁵ The appraiser for the lessor (*B.C. Rail Partnership*) estimated the fair market rental at \$45,000 per annum, equivalent to 10% of the market value of the bare land. Conversely, the appraiser for the lessee (*Pacific West Systems Supply Ltd.*) estimated the fair market rental at \$27,000, equivalent to 6% of the market value of the bare land. In coming to their divergent estimates of fair market rental, the appraisers offered the following explanations:

In reference to the lessor's appraisal report, the relevant sections were described as follows: In its report, North Country set out that, in their opinion, most ground leases impose use restrictions on the lessee. The evidence given was that the lessee often applies to modify the use restriction to reasonable alternatives and, in the opinion of North Country, in the subject case the lessor would have no cause to deny a reasonable use modification. As part of its report, North Country provided four market comparables, all in the Squamish area and all dealing with land leases or ground leases and the return to

the lessor based upon land values.

The lessee's appraiser, in concluding that the existing lease is restrictive and has a direct negative impact on its fair market rental, cited the following two factors:

The property cannot be used for any other purpose than [sic] the building supply use. As the Squamish market is a relatively small market and it is already serviced with one or two building supply facilities which are in superior locations for this purpose... [,] [t]here is a very severe lack of demand for this site as a building supply use.

The lease has [sic] a relative[ly] short tenure and the underlying land rent has to be reviewed again in five years. Therefore, the short tenure also limits the amount of investment or commitment a prospective tenant can put forward, in terms of time, capital and effort. On the basis of the appraisal evidence presented, the arbitrator sided with the lessor and concluded that fair market rental of lands is based upon the market value of the bare land, reasoning as follows:

I understand this to mean that the fair market rental value will only be arrived at by treating the lands as free and clear of restrictive clauses sought to be imposed on the lease negotiations other than those contained in the above definition.

Use restrictions are almost universally included in commercial leases and, if such restrictions are intended to be considered in arriving at a rental for a renewal period, this restriction would be specifically set out in the renewal provisions in the lease. The rent arrived at by...[the lessee's appraiser] is not the fair market rent as between this lessor and this lessee.

The arbitrator concluded that the lessee's appraiser's definition "does not form any part of the accepted definition of market rental value in Canada."

On its face, the arbitrator's interpretation of market rental value is inconsistent with the prevailing appraisal literature. In the summer 1998 issue of *The Canadian Appraiser*,⁶ market rent, in the context of a rent review or rent renewal, is defined as,

The rent that the property would most probably command in the open market at the time of the rent review or rent renewal for a stipulated period, pursuant to all of the subsisting terms and conditions of the existing lease, save and except the quantum of rent, the hypothetical landlord and hypothetical tenant each acting prudently and knowledgeably, and assuming the rent is not affected by undue stimulus.

Implicit in this definition is the consummation of a lease agreement as of a specified date for a specified term, with the use and occupancy of the property conveyed to the hypothetical tenant in exchange for the payment of rent to the hypothetical landlord, under conditions whereby:

- the hypothetical landlord and hypothetical tenant are typically motivated;
- both hypothetical parties are well informed or well advised, and acting in what they consider their best interests;
- a reasonable time is allowed for exposure in the open market;
- payment of rent is made in cash in Canadian dollars; and
- the rent represents the normal consideration for the property under the subsisting terms and conditions of the existing lease.

An estimate of market rent should be linked to an estimate of reasonable exposure time. Exposure time is the estimated length of time the demised premises, under the subsisting terms and conditions of the existing lease, would have been exposed for lease on the open market prior to consummation of a hypothetical lease at market rent on the rent review date (appraisal date) between a hypothetical landlord and a hypothetical tenant. The overall concept of reasonable exposure time encompasses not only adequate, sufficient and reasonable time, but also adequate, sufficient and reasonable effort. Reasonable exposure time can be expressed as a range and can be based on one or more of the following:

- statistical information about number of days on the market reflected by current listings and actual leases for comparable properties/premises;
- information gathered through verification of comparable lease transactions; and
- interviews with market participants such as leasing agents, property managers, landlords, developers, etc.

Further, *The Dictionary of Real Estate Appraisal*⁷ defines market rent as,

The most probable rent that a property should bring in a competitive and open market, reflecting all conditions and restrictions of the specified lease agreement including term, rental adjustment and revaluation, permitted uses, use restrictions, and expense obligations; the lessee and lessor each acting pru-

dently and knowledgeably, and assuming consummation of a lease contract as of a specified date and the passing of the leasehold from lessor to lessee under conditions whereby:

- Lessee and lessor are typically motivated.
- Both parties are well informed or well advised, and acting in what they consider their best interests.
- A reasonable time is allowed for exposure in the open market.
- The rent payment is made in terms of cash in United States[/Canadian] dollars, and is expressed as an amount per time period consistent with the payment schedule of the lease contract.
- The rental amount represents the normal consideration for the property leased unaffected by special fees or concessions granted by anyone associated with the transaction.

The contrasting positions of the parties in respect of the issue of fair market rent were set out as follows by the court:

- The lessee's argument is that restrictions on use [i.e., restricted highest and best use] must be taken into account when determining fair market rent unless clear language in the lease manifests a contrary intention.
- The lessor's position is that in assessing fair market rental a court must adopt an objective test, which does not take into account the particular circumstances or provisions of the lease and absent any express provision relating to use restrictions the court must not take them into account [i.e., unrestricted highest and best use]. In other words, if there is no provision regarding use restrictions, then they cannot be considered in assessing fair market rent. Moreover, it is argued that where there is a connection between the rent and the underlying value of the land, an objective approach is mandated and restrictions on use are not relevant.

As noted by the appeals court, the lease in dispute called only for an estimate of fair market rental. That objective differed from the language of the rent review clauses of the leases in the two cases cited, both of which dictated a two-step approach to estimating rental value. In the two cases cited, the primary objective was to estimate land value as bare land, to which was applied the interest rate (rate



of return) specified in the lease in fixing the annual rent. The disputed rent review clause did not specifically require a land value estimate, and, in turn, temporary suspension of the lease and subsisting lease terms, including the restriction on use, in fixing the fair market rental during the relevant period. In summary, the disputed rent review clause required an estimate of rental value rather than an estimate of land value.

The court turned its attention to *Canadian National Railway Company v. Inglis Ltd.*⁸, a similar case in which a rent review clause made no reference to land value, and where a restriction on the use of the land imposed on the lessee was taken into account in determining the rent. The court was dealing with the renewal terms of a commercial lease that restricted the lessee to use the land for manufacturing purposes only. Upon renewal, the lessor fixed the rent according to fair market value of the land based on its highest and best use. The lessee argued that the value ought to be based on its actual use by the lessee [in accordance with the use clause in the lease]... The court concluded that the rents ought to be calculated not by best use [i.e., highest and best use], but with a reference to the use imposed by the lease. The court took into consideration the fact that the land was restricted to manufacturing use...

[A]s a general proposition, valuations of land for the purpose of determining rent should take into account restrictions imposed by a lessor on the use of the land unless the lease contains some provision clearly manifesting an intention that the restrictions are not to be considered in fixing value. See, for instance, *Basingstoke and Dean Borough Council v. Host Group Ltd.*, [1988] 1 All E.R. 824 (C.A.); and *Plaza Hotel Associates v. Wellington Associates Inc.*, 285 N.Y.S. 2d 941; affirmed 293 N.Y.S. 2d 108 (C.A. 1986).⁹

Rather than remit the case to the arbitrator, the court fixed the fair market rental at \$27,000 per annum for the five-year period in question (September 1, 1999 - August 31, 2004), taking into account the use restriction imposed on the lessee, consistent with the position of the lessee's appraiser. Market rent is a function of utility (use) and the duration of the lease term covered by the rent review period (i.e., a five-year term would warrant a lower rent than a 10-year term). The court's interpretation of fair market rental

in *B.C. Rail Partnership (lessor) and Pacific West Systems Supply Ltd.* is consistent with the definitions of market rent found in the appraisal literature.

At the time of the rent review (September 1, 1999), the ground lease had a remaining term of 10 years, terminating on August 31, 2009. With only 10 years remaining on the ground lease, were the court to have affirmed the lessor's position of an unrestricted highest and best use, not many of the permitted uses under the prevailing zoning bylaw could have been shown to be financially feasible and maximally productive. Highest and best use is a four-prong test involving an analysis of uses that are legally permissible, physically possible, financially feasible, and maximally productive.

Conclusion

Whether a restriction on use in a ground lease should be considered in a rent review dispute to adjust and establish a new rent depends entirely on the language contained in the lease, in particular the rent review clause. As each ground lease is unique and property-specific, a complete and thorough reading of the particular ground lease is essential. A ground lease that does not require encumbrances¹⁰ to be ignored in fixing the rent at the time of rent review must take into account all of the subsisting terms of the existing ground lease, save and except the quantum of rent.

End notes:

¹ *Pacific West Systems Supply Ltd. v. B.C. Rail Partnership*, [2003] B.C.J. No. 565 2003 BCSC 391.

² *No. 100 Sail View Ventures Ltd. v. Jan-west Equities Ltd.*, (B.C.C.A.) [1993] B.C.J. No. 2338. Leave to appeal to the Supreme Court of Canada denied.

³ The dissenting opinion argued that the 50-year ground lease executed in 1981 contemplated construction by the tenant of a hotel on the site, while the landlord received a minimum base rent for the ground lease or a percentage rent calculated on the volume of business done by the hotel. The lease contained a restriction on use. Further, inclusion of the phrase 'bare land' in the ground lease was required so as to avoid valuing the land in an improved state at the expense of the tenant who had paid for the construction of the improvements. Imposing a restriction on use was likened to a restriction on use imposed by a zoning authority such as a municipality. On this basis, the dissenting opinion concluded that the use clause restricted the highest and best use of the land, which was not available to the tenant through the 50 years of the term of the lease or the renewal period of 25 years.

⁴ In 1965, the Crown entered into an agreement with a company unrelated to the Musqueam Indian Band. The company serviced and subdivided the land and the Crown provided the company with an individual 99-year lease for each lot. When the rent came up for review in 1995, the parties were unable to agree as to the meaning of 'current land value.' The Supreme Court's dissenting opinion concluded that 'current land value' means the price a willing buyer would pay for fee simple title to the land based on its highest and best use, and that this construction is consistent with the plain meaning of the language used in the leases and common industry practice. The only impediment to the Band's selling its land is the leases themselves, whose restrictions should be disregarded. With a remaining term of 69 years at the time of rent review, the market value of the leased interest would have been similar to the market value of the freehold interest, provided the ground lease did not negatively impact the availability of mortgage financing, including terms and conditions. The present value of \$1 per annum at 6% for 69 years is \$16.37, which compares to a value of \$16.67 for \$1 per annum at 6% in perpetuity. See Tony Sevelka, 'Ground Lease Interpretation – Rent Review and Adjustment Valuation Issues,' *The Canadian Appraiser* (Spring 2002), p. 28, for a discussion of the concept of perpetuity applied to lease terms of varying length.

⁵ While the decision is silent as to the zoning and highest and best use of the site, it is highly improbable that the market value of the site would be the same whether appraised on the basis of an 'unrestricted highest and best use' or 'restricted highest and best use permitting only a building supply use.'

⁶ Tony Sevelka, 'Rental Dispute Arbitration, Part I of II,' *The Canadian Appraiser* (September 1998), 34.

⁷ *The Dictionary of Real Estate Appraisal*, 4th ed. (Chicago: Appraisal Institute, 2002), 176.

⁸ *Canadian National Railway Company v. Inglis Ltd.* (1997), 153 D.L.R. (4th) 291 (Ont. C.A.). In this case, the rent review clause called for the fixing of the rent during the relevant five-year period "at an amount which in the opinion of the lessor is fair and equitable..." In fixing the rent, the court imposed an objective standard of reasonableness, meaning that the rent had to be fair and equitable between the parties to the lease, in the context of their lengthy landlord and tenant relationship, and in the light of all relevant circumstances.

⁹ For a discussion of this case, see Tony Sevelka, 'Ground Lease Interpretation-Rent Review and Adjustment Valuation Issues,' *The Canadian Appraiser* (Spring 2002): 30-31.

¹⁰ An encumbrance can be "[a] claim, lien charge, or liability attached to and binding real property; e.g., a mortgage; judgement lien; mechanics' lien; lease; security interest; easement or right of way; accrued and unpaid taxes. *Black's Law Dictionary*, Centennial Edition (1891-1991). ♣

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