

ABSTRACT

The varied and unique challenges presented in the valuation of long-term ground leases with rent reset or rent review clauses have not been extensively addressed in appraisal literature. Collectively, less than a handful of articles about ground leases have been published in *The Appraisal Journal*. Most of the guiding principles underlying rent reset valuation, however, stem from case law in common law jurisdictions such as the United States, Canada, and Britain. This article discusses ground lease rent reset issues and related court cases.

Ground Leases: Rent Reset Valuation Issues

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While there are recognized and well-established valuation methods and techniques, the application of a particular valuation procedure to resolve a ground lease problem is always a function of the language contained in the ground lease—in particular the rent reset clause—and any constraints imposed by the quality and quantity of available market data. Problem identification always starts with a thorough reading of the lease, paying particular attention to relevant provisions, definitions, and descriptions of terms essential to the valuation process.

All opinions of value involve some aspect of real estate law. In specialized areas such as ground lease valuation, an awareness of relevant case law is paramount in developing and applying appropriate valuation methods. A basic understanding of contract law and an ability to interpret various legal documents, including leases, are important. Appraisal assignments involving potential arbitration and litigation often require the guidance of legal counsel. Conflicting interpretations of lease provisions at the time of rent review often lead to divergent and irreconcilable opinions of value, and resolution of a ground lease valuation dispute may require the court's intervention and guidance.

Ground Leases

A ground lease is an enforceable contract that creates a lessor's interest and a lessee's interest in a legally defined parcel of land, where virtually all of the incidents of ownership are transferred from the landowner to the lessee for the entire term of the ground lease. The landowner retains the reversionary interest in the land realizable upon expiration of the ground lease. The lessor's interest is known as the *leased fee* interest, while the tenant's interest is referred to as the *leasehold* interest. Both the lessor and the lessee enjoy rights and privileges and are subject to obligations and restrictions, as agreed upon and spelled out in the executed ground lease, and which the courts strictly interpret. A *ground lease* is variously defined as follows:

- A lease of vacant land, or land exclusive of any buildings on it, or unimproved real property. Usually a net lease.¹

1. *Black's Law Dictionary*, Centennial Ed. (1891–1991), 6th ed., 704.

- Usually a long-term lease of land with the lessee permitted to improve or build on the land and to enjoy those benefits for the term of the lease.²
- A lease that grants the right to use and occupy land. Improvements made by the ground lessee typically revert to the ground lessor at the end of the lease term.⁵

Aside from the financial benefits available to the landowner for entering into a long-term lease, there must be sufficient financial incentive (reward) for a prospective lessee (developer) to commit time, effort, and capital into undertaking site and building improvements, and marketing the finished product, if the developer is not an end user. The lease term must be of a sufficient length so the prospective lessee (developer) can amortize or recapture his or her investment. Moreover, the term of the ground lease must be of sufficient length to allow the lessee (developer) to obtain third-party leasehold mortgage financing on terms and conditions that make the proposed development financially feasible and to accommodate subtenant occupancy leases. Sometimes, the length of the ground lease is tied to the expected economic life of the proposed leasehold improvements.

A leasehold interest in unimproved land is less valuable than the corresponding freehold interest in the same land. Likewise, a 99-year lease will have a value much higher than a 40-year lease relative to the freehold value of the same land. The degree of relativity, expressed as a percentage of the freehold value, will vary between one type of property and another and from area to area, with the predominant factor being the length of the term, especially in a mortgage-dependent market. Over time, the value of a leasehold position gets progressively less as the lease approaches the expiration date, when the income from existing or future subtenant occupancies ceases and

the land (including existing leasehold improvements) reverts to the freeholder (landowner).⁴

Rent Reset Clauses

Rent reset clauses provide the mechanism to adjust the ground rent payable by the lessee at predetermined intervals throughout the life of a long-term ground lease. In *Basingstoke and Deane Borough Council v. Host Group Ltd.*,⁵ the court describes the mechanism and objective of rent review clauses, and the role of the appraiser:

The means by which rent review clauses afford landlords relief in respect of increases in property values or falls in the value of money is by providing, normally, for a valuer, in default of agreement, to assess the up-to-date rent for the demised premises at successive review dates. In making that assessment the valuer will be achieving the intended purpose of keeping the rent in line with current property values having regard to the current value of money if, but only if, he assesses the up-to-date rent on the same terms (other than as to the quantum of rent) as the terms still subsisting between the parties under the actual, existing lease.

Nonetheless, the parties to a ground lease are free to deviate from reality and structure a rent reset clause in any manner they deem appropriate, even if the basis for determining rent bears no relationship to what has actually been leased or to any of the other subsisting clauses in the ground lease, including the remaining term of the lease.⁶ Also, there is no prescribed length of time between rent reviews, which largely depends on the length of the overall term of the ground lease. Generally, ground leases with terms less than 40 years have scheduled rental payments established at the commencement of the lease that cover the entire term of the ground lease.

Development on leased land for which ground rents have not been predetermined is difficult to finance. Ground rent payments, unless specifically

2. International Valuation Standards (IVS) Glossary, in Appraisal Institute, *Dictionary of Real Estate Appraisal*, 5th ed. (Chicago: Appraisal Institute, 2010), 249.

3. *Dictionary of Real Estate Appraisal*, 92.

4. In Canada, the Central Mortgage and Housing Corporation (CMHC) considers a 60-year land lease intended to accommodate residential use as being equivalent to 75% of the value of outright ownership. See, http://www.cmhc-schl.gc.ca/en/inpr/afhoce/tore/afhoid/fite/lale/lale_001.cfm. Research conducted by Capozza and Sick indicated that 80-year to 90-year prepaid land leases with single-family dwellings in the Salish Park area of the City of Vancouver, Canada, sold for a 20% to 40% discount from comparable fee-simple properties in the adjacent Dunbar and Kerrisdale areas. See "Valuing Long-Term Leases: The Option to Redevelop," *Journal of Real Estate Finance and Economics* 4 (1991): 209.

5. *Basingstoke and Deane Borough Council v. Host Group Ltd.*, [1988] 1 WLR 348, 56 P&CR 31, 284 EG.

6. In *McDonalds Real Estate Ltd Liability Partnership v. Arundel Corporation*, [2008] 2 EGLR 53, [2008] EWHC 377 (Ch), McDonalds entered into a 50-year ground lease for a 1.3-acre site in 1985 for the purpose of developing its first drive-thru restaurant in the UK. The lease contains covenants to comply with the Planning Acts and to use the demised premises only as a restaurant, together with ancillary office accommodation, storage, staff facilities and car-parking space in connection therewith, or for such other retail uses the landlord might authorize, such authority not to be unreasonably withheld or delayed. The rent is to be reset at 5-year intervals throughout the term of the lease on the understanding that the second method of estimating market rent at each rent review is to assume a term of 20 years, regardless of the actual remaining term, and is to apply to both the land and a hypothetical "modern single storey warehouse comprising 20,000 net useable square feet of which 15% were useable as ancillary offices and constructed to a high standard in accordance with all statutory and other relevant consents with all usual amenities including adequate parking and loading facilities."

subordinated, take priority over any mortgage payments associated with leasehold improvements. Unless ground rents are fixed throughout the term of the ground lease, the mortgage lender has no practical way of protecting its financial interest against anticipated spikes in future ground rent payments that may overwhelm the earning capacity of the leasehold improvements and cause the lessee to default on the ground lease, putting the leasehold mortgagee at financial risk. Many lenders refuse to underwrite loans for leasehold improvements unless the ground rent has been prepaid or the amount of ground rent can be reasonably ascertained throughout the entire term of the ground lease and sustained by the potential income generated from subtenant occupancies.

Leasehold mortgagees are extremely cautious and apply conservative underwriting standards that typically require repayment of self-liquidating mortgage loans at least 10 years prior to the expiration of the existing lease term. Leases whose unexpired terms are less than 20 years are generally not considered suitable for mortgage financing. Leasehold mortgages, as commercial mortgage-backed securities, also carry greater financial risk.

Amortization of the costs of leasehold improvements requires that the ground lease be of a sufficient length for the lessee (developer) to recover his or her entire investment in the leasehold improvements while in possession of the land, which will revert to the landowner upon expiration of the ground lease. Depending on the use of the land and scale of development, amortization of major leasehold improvements in most instances will require a minimum of 40 years to permit the lessee (developer) to recover the investment and facilitate leasehold mortgage financing; most long-term leases run 50 to 99 years. Low order uses, such as gas stations and fast food outlets with low floor area ratios (FARs), may only require a 20-year ground lease.

Highest and Best Use⁷

A rent reset clause may instruct an appraiser to ignore both the improvements and the lease itself, valuing the land in fee simple and as if unencumbered and available for ground-up development in perpetuity.

This type of rent reset clause facilitates an unrestricted highest and best use analysis,⁸ which may or may not result in the highest or most probable ground rent at the time the rent is to be reset.

A restricted highest and best use analysis flowing from the provisions of a lease that dictate a specific or limited number of uses (which may or may not be legally permissible under the land use controls prevailing at the date of the rent review) can result in rental payments that are either lower or higher than those achievable based on an unrestricted highest and best use analysis. Similarly, where a lease dictates scale of development either less than or greater than permitted under the provisions of the prevailing land use controls, it too leads to a restricted highest and best use analysis, and can result in rental payments that are lower or higher than those achievable based on an unrestricted highest and best use analysis.

A rent reset clause that fails to specifically state that the lease itself is to be ignored imposes time constraints on the investment horizon, resulting in a restricted highest and best use analysis. The length of time remaining on the lease, including any extension of the lease term exercisable at the discretion of the tenant at the time of the rent review, may cause some or all of the uses permitted under the prevailing land use controls or those strictly dictated by the lease to be financially infeasible for ground-up development. This results in rental payments lower than those achievable based on an unrestricted highest and best use analysis. In this sense, a ground lease is similar to a space lease, whose length of occupancy available to the tenant is determined by the term of the lease. In defining a ground lease valuation problem in the context of highest and best use, the most critical and interrelated issues confronting the appraiser are as follows:

- The identification of what is to be appraised (i.e., land only or land and improvements), based on a thorough reading of the lease or as instructed by legal counsel.
- The constraints of the lease, if any, imposed on highest and best use analysis, to determine whether the valuation is of the fee simple interest or of the estate for years,⁹ reflecting the period

7. Whether highest and best use analysis of land is undertaken on an unrestricted or restricted basis, the highest and best use must still be legally permissible, physically possible, financially feasible, and maximally productive. Appraisal Institute, *The Appraisal of Real Estate*, 13th ed. (Chicago: Appraisal Institute, 2008), 278–279.

8. This is analogous to valuing a property as if vacant, unimproved, and unencumbered, and, in the absence of a jurisdictional exception, may require the appraiser to impose a hypothetical condition on the highest and best use analysis.

9. Also known as a *tenancy for years*, and defined as “a leasehold interest in real estate established by a contract for possession for a specified period of time.” *The Dictionary of Real Estate Appraisal*, 195.

remaining on the lease at the time of the rent review.

- The legally permissible use(s) governed by the prevailing land use controls or the use(s) dictated by the language of the lease.
- The scale of development legally permissible pursuant to the provisions of the prevailing land use controls or the scale of development dictated by the language of the lease.
- The physical constraints of the land, if any, imposed on the scale of development either legally permissible or dictated by the language of the lease.
- The remaining term of the lease, including any renewal options exercisable at the discretion of the lessee.
- The marketability and financial feasibility of the legally permissible use(s) or the use(s) dictated by the language of the lease, and achievable in the context of the remaining term of the lease, including any renewal options available to the lessee.

Market Analysis

Through supply and demand analysis, the appraiser identifies and tests the level of market support for legally permissible and physically possible uses, while recognizing any restrictions or constraints imposed by the lease. Sufficient market demand is a precursor of highest and best use analysis in the context of financial feasibility of a particular use and scale of development that has passed the initial tests of legal permissibility and physical possibility.

For example, in *Michelson*,¹⁰ insufficient demand for office space rendered the hypothetical development of an office tower on the leased land infeasible at the date of the rent review, reinforcing the critical role of supply and demand in highest and best use analysis. The ground lease was for a term of 55 years, with the rent scheduled to be reset initially at the end of the 25th year of the lease term. The lease provided as follows:

Upon the expiration of the twenty-fifth (25th) year...of the term of this Lease, the basic rental shall be adjusted to that sum which the Lessor could derive from said property if it were made available on the open market for new leasing purposes for...[office] use (exclusive of the value of Lessee's improvements thereon);

On the date of the first rent review, the remainder of the initial lease term was 30 years, with the parties reaching consensus on the following issues:

The parties agree the lease requires the rent adjustment, 'if any,' to be decided on the basis of a valuation of a hypothetical transaction...First, it must be imagined the improvements to the Property do not exist, because the rent for the Property must be determined 'exclusive of the value of Lessee's improvements thereon.' Second, the relevant question is the market valuation of a new 55 year ground lease in 2002, with the same terms and conditions as those contained in the original ground lease (other than an adjustment of dates). This interpretation follows from the lease's directive to adjust the rent based on making the Property available 'on the open market for new leasing purposes...'. Neither party contends the lease demands a valuation of a 30 year ground lease (the remainder of the actual term), which would presumably reduce the value of the leasehold. The parties stipulate that the only permitted use of the Property in 2002 was for an office building similar in size to the building actually in existence.

The rent adjustment clause called for an estimate of basic rent, but as no provision in the lease instructed the appraisers to assume a 55-year term, application of land residual analysis should have reflected an economic life of 30 years for the hypothetical leasehold improvements, consistent with the remaining term of the lease. The court considered what was the appropriate valuation methodology and what assumptions were appropriate in applying that methodology to the ground lease at issue.

In *Michelson*, the landowner's appraiser relied on a land residual analysis as a check against the freehold land value estimate derived from the sales comparison approach. The lessee's appraiser relied on land residual analysis solely to demonstrate a lack of financial feasibility stemming from a lack of demand for office space, a position supported by an absence of any new office development and an extremely high office vacancy rate in the local market. The appeals court upheld the trial court's ruling that no increase in basic rent was warranted:

We agree with *Michelson* that...[its appraiser's] approach measures the economic feasibility of the ground lease transaction proposed in the rent adjustment provision. We further agree that the court was entitled to rely on a measurement of economic feasibility as a prerequisite to the assumption that a ground lease transaction would actually be consummated on the 'open market'...

10. 2151 *Michelson, L.P., v. Corp. of The Presiding Bishop of The Church of Jesus Christ of Latter-Day Saints*, G039654, 2008 Cal. App. Unpub. LEXIS 10002.

[I]n the statement of facts, the cap rate used by the experts in calculating the feasibility of a ground lease at the Property is issue determinative....The lease calls for an upward adjustment of rent if the rent that could be derived exceeds \$88,165. Using [the landowner's appraiser's] cost (\$13,497,000) and NOI (ignoring ground rent, \$1,525,838) assumptions, the margin for paying ground rent gradually evaporates upon increases in the assumed [building] cap rate:

Cap Rate (R _n)	Feasibility Income to Support Residual Construction Costs	Ground Rent
8.25%	\$1,115,502	\$412,536
9.00%	\$1,214,750	\$511,108
9.70%	\$1,309,209	\$216,629
10.00%	\$1,349,700	\$176,158
11.00%	\$1,484,670	\$41,168
15.00%	\$2,024,550	-\$498,712

[The lessee's appraiser's] methodology does not directly determine market rent; it determines whether sufficient income would be generated to make the deal rational for both the ground lessor and ground lessee.

Testing the Legal Permissibility of Land as though Vacant

In applying the test of legal permissibility, the appraiser determines which uses are permitted by current zoning, which uses could be permitted if a zoning change were granted, and which uses are restricted by private restrictions on the site. Private restrictions, deed restrictions, and long-term leases may prohibit certain uses or specify building setbacks, heights, and types of materials. If deed restrictions conflict with zoning laws or building codes, the more restrictive guidelines usually prevail. A long-term lease may affect the highest and best use because lease provisions may limit use over the remaining term of the lease.

Testing the Financial Feasibility of Land as though Vacant

Only those uses whose value is commensurate with cost, and which are legally permissible and physically possible, are considered financially feasible. For

income properties, the analysis focuses on potential uses that are likely to produce an income (or return) equal to or greater than the amount needed to cover operating expenses, financial obligations, and capital amortization of the investments. Any external obsolescence related to a specific use should be incorporated into the test of financial feasibility.

Timing for a specific use is a function of supply and demand, and refers to when improvements should be built in conjunction with future expectations of occupancy and rent levels. Land and location favor financially feasible uses with near-term development potential, as near-term development land is more valuable today due to the time-value of money and the risk profile.

Financeability of Leasehold Improvements

Appraisers often overlook or underestimate issues associated with the financeability of leasehold improvements in ascertaining financial feasibility as part of highest and best use analysis. A ground lease has priority over a leasehold mortgage unless the lease has been subordinated in favor of the leasehold mortgagee. As a general rule, leasehold financing is more costly than financing a fee simple interest. Some of the issues that should be considered in addressing financeability of leasehold improvements and the impact on highest and best use analysis are:

- The ground lease itself as an encumbrance against the property, and whether the lease is assignable and mortgageable¹¹
- The use(s) permitted by the ground lease (a narrow range of permitted uses will appeal less to a mortgage lender, and vice versa)
- The term remaining on the ground lease at the time of the rent review (a short remaining term will appeal less to a mortgage lender, and vice versa)¹²
- The frequency of rent resets during the remaining term of the ground lease (more frequent rent resets will appeal less to a mortgage lender, and vice versa)

11. *Airport Plaza, Inc. v. Gladys Motley Blanchard*, 188 Cal. App. 3d 1594; 234 Cal. Rptr. 198; 1987 Cal. App. LEXIS 1346. In denying *Airport's* request to mortgage its leasehold estate and dissolve the corporation and assign its assets, including the ground lease, to its two shareholders, the appeals court found that hypothecation constitutes an assignment of less than the entire leasehold, which is prohibited by the ground lease without the consent of the landowner. The court further found that no commercial lender would make a loan without requiring the landowner to consent to conditions, which would amount to an amendment of the ground lease. The court also found that the lessee was entitled to assign the entire leasehold estate without the landowner's consent, but only if the assignor remained personally liable on the ground lease.

12. The City of Vancouver was compelled to extend all of its existing 40- and 41-year ground leases, thereby enabling cash-starved housing cooperatives to obtain leasehold mortgage financing to cover the high cost of building envelope failure associated with many housing projects. *Housing Policy Report*, Vancouver City Council, February 16, 2005, CC File No.: 4664.

- The required or anticipated method of rent adjustment
- The right of the mortgagee to cure any default by the lessee of the provisions of the ground lease
- The right to reconstruct damaged leasehold improvements
- The lease provisions, if any, that provide mortgagee protections

In the context of land assumed to be unimproved, those uses found to be financially feasible are tested to ascertain the comparative productivity of each use and to determine which use produces the maximum productivity. Different uses have different risk profiles and varying rates of return are demanded by market participants at different points in time.¹⁵ Of the financially feasible uses tested, the highest and best use is the use that produces the highest residual land value, consistent with the market's perception of risk and the rate of return demanded by the market for the perceived risk associated with the use.

Absent any legislative or public policy constraints, determining financial feasibility is a collaborative effort between landowner and lessee, with each party wanting to maximize its financial position by working to reach a consensus as to the most productive use(s) to be made of the land within the term of the ground lease. When the rent is to be reset during the term of the lease, the initial use(s) and scale of development may no longer be financially feasible due to changes in market conditions and limitations imposed by the language and remaining term of the lease. A use predetermined or dictated by the language of a lease may not be financially feasible at the time of rent review, which can negatively impact the earning potential of the land.¹⁴

Distinguishing Between Market Value and Market Rent

Market value concerns itself with vendors and purchasers, whereas market rent only pertains to

lessors and lessees, a distinction articulated in *Bondi v. City of Toronto*.¹⁵ In that case, the appeals court rejected the appraiser's estimate of rent and the two-step methodology of estimating rent based on the unrealizable value of the land in its (unrestricted) highest and best use.

[The appraiser founded his] opinion as to the present sale value of the land viewed from the angle of its redevelopment potentiality. Even assuming that this was a perfectly proper manner of fixing the value of the freehold to the owner thereof who would eventually realize that potentiality, there was a complete absence of evidence as to what part, if any, of that potentiality would be realized during the 21-year period of the lease for which the rent was to be fixed.

In the rental dispute between B.C. Rail Partnership (lessor) and Pacific West Systems Supply Ltd. (lessee),¹⁶ the ground lease was for a term of 20 years, and included a provision for reviewing the rent at five-year intervals. The rent was to be adjusted in accordance with a clause stating "the revised rental shall reflect a fair market rental on the date of such adjustment." The appeals court noted the lease called only for an estimate of fair market rental, and that objective differed from the language of the rent review clauses of the ground leases in the two other cited cases¹⁷ that had dictated a two-step approach to estimating renewal rent. In the two cases cited, the primary objective was to estimate land value as bare land, to which was applied the rate of return specified in the lease in fixing the new annual rent.

A similar distinction was drawn between market rental value and market value in *Bullocks' Inc. v. Security-First National Bank of Los Angeles*.¹⁸

Rental value is measured partially in terms of time, by the month or by the year, et cetera. The parties were not fixing rental value in the lease, they were fixing rent. They determined such rent by taking a...fixed percentage of the full value (not the rental value) of the land. The parties based rent upon the fair market value of the property rather than upon its rental value for any given period of time.

13. Investors will accept different rates of return, depending upon investment alternatives and differing levels of risks inherent in the use, location, and other characteristics of the property.

14. 2151 *Michelson, L.P. v. Corp. of The Presiding Bishop of The Church of Jesus Christ of Latter-Day Saints*.

15. In *Bondi v. City of Toronto*, [1967] O.J. No. 1112, the land was leased for 21 years, with the lessor granting the lessee a further 21 years at an agreed upon rent to be "at such rent per foot frontage per annum as the said demised premises shall be worth irrespective of any improvements made thereon by the lessee or any prior lessee thereof."

16. *Pacific West Systems Supply Ltd. v. B.C. Rail Partnership*, 2003 BCSC 391, 2004, BCCA247 (Can LII).

17. *No. 100 Sail View Ventures Ltd. v. Janwest Equities Ltd.*, (B.C.C.A.) [1993] B.C.J. No. 2338. (Leave to appeal to the Supreme Court of Canada denied.) and *Musqueam Indian Band v. Glass*, 2000 SCC 52, [2000] 2 S.C.R. 633.

18. *Bullock's Inc. v. Security-First National Bank of Los Angeles*, 160 Cal. App. 2d 277; 325 P2d 185; 1958 Cal. App. LEXIS 2119.

Valuation Premise

Contested rent reset clauses accompanied by a lack of appropriately defined or described terms can lead to widely divergent conclusions as to the interest to be appraised (freehold or remaining lease term),¹⁹ the nature of the demised premises (land or land and improvements), and the highest and best use. Courts in common law jurisdictions have consistently held that the lease itself, as an encumbrance,²⁰ is a restriction on the use of land that must be taken into account in fixing the rent unless the lease contains language to the effect that the lease is to be ignored.²¹ The following cases illustrate this point.

In *New York Overnight Partners v. Gordon*,²² the rent for the 15-year renewal term of the lease was to be calculated at 6.5% of the “appraised value of the land.” The lease expressly excluded from the definition of *land* the “buildings and improvements thereon erected.” When the parties failed to reach consensus on the meaning of the phrase “appraised value of the land,” they sought judicial interpretation to settle the dispute. The appeals court upheld the lower court’s findings that, “the appraiser must determine the value of the land as though vacant, without improvements,” because the lease expressly provided that the appraiser value the land as unimproved. Pursuant to the express terms of the ground lease, the parties did not intend the land to be appraised for its highest and best use as currently improved to establish the rental rate for the renewal term.²³

In *Ruth E. Abers et al., v. Christine Marie Rounsavell*,²⁴ the rent for the leased land was to be reassessed after 30 years, adjusted to 8% of the then current fair market value, exclusive of all land improvements. The dispute focused on the meaning of “leased land” as used in 150 single-unit leases

created on an 18.5-acre parcel developed as a leasehold condominium project. In 1969, the landowner initially entered into a unitary ground lease for 55 years with a developer to lease 18.5 acres for development as apartments. In 1974, the ground lease was amended and conveyed to another developer for a term of 75 years to accommodate a phased 150-unit condominium project, with the ground lease converted to 150 individual leases. As the units were sold, each purchaser signed an assignment for the particular described condominium. The assignment contained the same legal description of the leased property as the ground lease to which it pertained. In May 1975, with the division of the ground lease into separate condominium leases, the landowner and developer formally cancelled the ground lease. *Leased land* was defined as a specified condominium unit along with an undivided interest in the common area in each of the two leasehold condominium parcels. In addressing the meaning of leased land, the trial court concluded leased land meant “the entire 18 and one-half acre parcel of land on which the condominium complex was located” and that “the 18 and one-half acre parcel would be assessed at its ‘highest and best use.’” In overturning the lower court’s ruling, the appeals court observed:

The plain language in the recorded deeds gives rise to the reasonably justified expectation that the rent adjustment clauses will be limited to the fair market value of the leaseholds for the [150] individual condominium units, rather than fair market value of the entire 18 and one-half acres.

In *853 Seventh Ave. Owners*²⁵ the court examined the term *demised premises* in lease provisions. The court commented as follows:

In [the opinion of the Court of Appeals in *936 Second Ave. L.P. v. Second Corporate Dev. Co., Inc.*], where

19. David C. Lennhoff, “You Can’t Get the Value Right If You Get the Rights Wrong,” *The Appraisal Journal* (Winter 2009): 60–65. See “Letters to the Editor” and author’s follow-up responses (Summer 2009): 274–283 and (Winter 2010): 112–114.

20. Any right to, or interest in, land which may subsist in another to diminution of its value, but consistent with the passing of the fee by conveyance. *Knudson v. Weeks*, D.C.Okla., 394 F.Supp. 963, 976. A claim, lien, charge, or liability attached to and binding real property; e.g., a mortgage; judgment lien; mechanics’ lien; lease; security interest; easement or right of way; accrued or unpaid taxes. If the liability relates to a particular asset, the asset is encumbered. *Black’s Law Dictionary*, 527.

21. “Absent an agreement to the contrary, the effect of a net lease must be considered in valuing property for the purpose of setting rent for a renewal lease term.” *936 Second Ave. L.P. v. Second Corp. Dev. Co.*, 10 N.Y. 3d 628 (2008); accord *New York Overnight Partners*, (“[w]hen the language of the lease so dictates, appraisals must take into consideration all restrictions...as well as the lease term”). Such a rule comports with precedent, appraisal practices and common sense. *201–203 Lexington Ave. Corp. v. 205/215 Lexington Ltd. Partnership*, 224 AD2d 183 [1st Dept 1996], lv denied 88 NY2d 813 [1996]; *Ruth v. S.Z.B. Corp.*, 2 Misc 2d 631 [Sup Ct, NY County 1956], aff’d 2 AD2d 970 [1st Dept 1956]; *936 Second Ave. L.P. v. Second Corp. Dev. Co.*, 10 N.Y. 3d 628 (2008).

22. *New York Overnight Partners v. Gordon*, 88 N.Y.2d 716; 673 N.E.2d 123; 649 N.Y.S.2d 928; 1996 N.Y. LEXIS 3059.

23. The appeals court rejected the landowner’s position that consideration should be given to the “more advantageous use of the land...valued as a parcel of property permitting usage of a building containing 152,000 square feet of floor space thereon, rather than as a theoretically vacant and unimproved parcel.”

24. *Ruth E. Abers et al., v. Christine Marie Rounsavell, as Trustee, et al*, 189 Cal. App. 4th 348; 116 Cal. Rptr. 3d 860; 2010 Cal. App. LEXIS 1788.

25. *853 Seventh Ave. Owners v. W & HW Realty Co.*, 2010 NY Slip Op 01420.

the determination of rent for the net lease was to be based on “the value of the demised premises with all buildings and improvements thereon including any and all improvements erected by Tenant”..., the Court found that the net lease itself was to be taken into account in determining the rent...Since the wording of the lease here at issue specifically excludes buildings or improvements, as well as the lease itself, from the determination of value, the finding in *936 Second Ave.* is of no effect.

In *Revenue Properties v. Victoria University*,²⁶ the arbitrators fixed the renewal rent for the demised premises both as unencumbered and encumbered by the lease, leaving the court to interpret the rent reset clause. The lease did not indicate that the lands were to be considered as if unencumbered; therefore, the court ruled that the valuation had to take into account the lease as an encumbrance against the lands. According to the court, to do otherwise, “would be to ignore the very basis of the relationship between the parties as a landlord and tenant and would create a highly artificial situation.” The court went on to note “the entire arbitration is because there is a lease. Therefore it is necessary to acknowledge that the lands are subject to a lease even without considering the specific details of the lease.”

In *City of Vancouver v. David William Martin et al.*²⁷ the arbitrators reached a similar conclusion and recognized the lease itself as an encumbrance by drawing a distinction between unencumbered fee simple value and “market rental value of the said lands,”²⁸ stating that “the direction in the Model Lease is to determine the market rental value.” In reaching this conclusion, the arbitrators relied upon the following two cases:

- *No. 100 Sail View Ventures Ltd. v. Janwest Equities Ltd.*,²⁹ where the court considered a rent review

provision that required that the new rent be “10% of the fair market value of the Leased Premises as bare land at the date of the review.” The issue was whether this language required that use restrictions in the lease be taken into account when arriving at the “fair market value of the Leased Premises as bare land.” The finding of the majority of the court was that the phrase “fair market value of the Leased Premises as bare land” meant that the valuation had to be done without reference to the lease and consequently without reference to the restricted use found in the lease.³⁰

- In *Pacific West Systems Supply Ltd. v. B.C. Rail Partnership*,³¹ the court of appeals considered whether the use restrictions in the lease should be taken into account when a rent review provision required a determination of “fair market rental.” As in *No. 100 Sail View*, the review provision stipulated that improvements created by the tenant were to be disregarded. The landlord argued that as the improvements were to be disregarded, it followed that the use restrictions in the lease also should be disregarded. The court disagreed, and distinguished this case from *No. 100 Sail View* on the basis that in that case the lease called for a determination of “the fair market value,” whereas the lease in *Pacific West* required a determination of “market rental.” The court found that to determine market rental “the terms of the lease the tenant holds are critical,” and that there was “no sound basis on which it can be said that the parties to this lease can have intended that the tenant be put in the position of paying rent based on the unrestricted use of the lands when it is precluded from enjoying what may be the highest and best use.”³²

26. *Revenue Properties v. Victoria University*, [1993] O.J. No. 843, 101 D.L.R. (4th) 172.

27. *City of Vancouver v. David William Martin et al.*; retrieved April 4, 2011 from http://www.geoffmeggs.ca/wp-content/uploads/2011/03/Arbitral_Award.pdf.

28. “‘Said Lands’ in both the Ground Lease and the Model Strata Lot Lease are defined as ‘Lot 9, False Creek, Plan 16003.’”

29. *No. 100 Sail View Ventures Ltd. v. Janwest Equities Ltd.*, [1993] B.C.J. No. 2338, [1994] 2 W.W.R. 396.

30. In *Choosing the Right Words: Interpreting Rent Review and Renewal Clauses in Commercial Leases*, Menzies observes that the court referred to the decision in *Basingstoke*, but declined to follow it. “Since *Basingstoke* also referred to the rent being assessed as ‘a bare site,’ the decision in *Janwest Equities* calls into question in British Columbia the approach adopted by the English Court of Appeal in *Basingstoke* when faced with the words ‘as bare land’ or ‘as a bare site’ in a rent review or renewal clause. It is difficult to understand the reasoning of the majority in *Janwest Equities* and its conclusion that bare land means land unencumbered by a lease. A more logical interpretation is that bare land means land without buildings constructed thereon since there can be bare land encumbered by a lease restricting its use. ...[I]f a landlord wishes for the assessment to be made without reference to the lease encumbering the land, it should expressly state this in the rent review or renewal clause.”

31. *Pacific West Systems Supply Ltd. v. B.C. Rail Partnership*, 2003 BCSC 391, 2004 BCCA 247 (Can LII).

32. “[O]ther authorities cited by the Lessees are consistent with the distinction discussed in *Pacific West*; see, for example, *CNR v. Inglis*, 1997 CanLII 1070 (Ont. CA); *Basingstoke and Deane Borough Council v. Host Group Ltd.* [1988] 1 A11 E. R. 824; *Plaza Hotel v. Wellington Associates*, 55 Misc. 2d 843 (1967, Supreme Court of New York). In *Revenue Properties Co. v. Victoria University*, [1993] O.J. 843, even though the lease contained language very similar to the lease in *No. 100 Sail View*, the Ontario Court of Appeal found that the lands to be valued must be valued as encumbered by the relevant lease as to do otherwise ‘would create a highly artificial situation.’”

In *Manhattan Church of Christ Inc. v. 40 East 80 Apt. Corp.*, a lease provision explicitly excluded the lease, as well as the improvements, from consideration in estimating the “fair market value” of the land. The lease stated, “The basic rent...during each 20 year period...shall be an amount per annum equal to 6 percent of the fair market value...of the land..., considered as vacant, unimproved and unaffected by this lease...”³³ Conversely, in *Plaza Hotel Assocs. v. Wellington Assoc.*,³⁴ the rent reset clause did not contain the language “unaffected by this lease,” and, therefore, the court considered the lease restriction regarding the use of the property, as it caused the property not to be put to its (unrestricted) highest and best use.

A more recent decision, *Basingstoke and Deane Borough Council v. Host Group Ltd.*,³⁵ also held that if a rent review clause makes no provision to ignore the lease itself, all of the subsisting terms and conditions of the lease must be taken into account in estimating ground rent. The ruling makes no distinction between land leases and land and building leases. Arguing in favor of a presumption founded on the reality of the entire ground lease, the appeals court articulated its position as follows:

The declaration...made by the judge was that the valuer should assess the up-to-date rental value on the basis that the demised premises were available for letting on the terms and conditions of a hypothetical lease containing ‘such terms and conditions as the valuer regards as reasonable for a lease of a bare site for development current at the relevant date’ and that the site is available for any lawful use. This construction of para (vii) [the rent review clause] would mean that the valuer’s role would not be confined...to assessing the value of a property with stated characteristics. His role would extend to choosing some of the characteristics of the property...namely ‘such terms and conditions as the valuer regards as reasonable for a lease of a bare site at the relevant date.’ Paragraph (vii) contains no express direction giving such a power to the valuer. ...the natural (and, indeed necessary) implication from the terms of para (vii) read as a whole in its context in this lease is that the rental value to be assessed by the valuer is of a notional letting on the same terms (other than as to quantum of rent) as those subsisting between the actual parties to the lease but modified to the extent expressly provided...

Remaining Term of Lease

The term remaining on the lease, plus any term extension provided by way of a renewal option exercisable at the discretion of the lessee, is an important consideration in determining the highest and best use of a property. Highest and best use analysis is not only concerned about the timing of a particular use and scale of development, but it is also sensitive to the length of time required to fully amortize the investment in a particular development by providing the lessee with both a return *on* and return *of* the investment and ensuring third-party mortgage financing can be obtained for leasehold improvements.

When development costs required to support a particular use and scale of development cannot be financed and/or recovered by the lessee (developer) over the remaining term of a ground lease, including any renewal option, that particular use is precluded from consideration as a candidate for highest and best use. Highest and best use analysis is forward-looking from the date the rent is to be reset rather than from the date the lease was initially executed, regardless of whether the lease itself is to be ignored. The term remaining coupled with any extension of the term available to the lessee are taken into consideration in reaching a conclusion as to highest and best use over the investment horizon. This means that the amount of potential rent flowing from a particular use is dependent on the term of the lease remaining at the date of rent review.

In *United Equities v. Mandordic*,³⁶ the court, in a split decision, concluded that the value of the land should be appraised according to its highest and best use, and not as only a garage. The court said, however, that consideration would have to be given to the term of the lease and the renewal option in determining the use to which the land could be put. Weis characterizes this court decision as follows.³⁷

Presumably, the intent of the majority opinion was to instruct the appraiser: Go ahead and appraise the property for its highest and best use. But bear in mind that the lease has 21 years to go with one more renewal option for 21 years. When you value the land for its highest economic use, remember that you only have the right to use the land for a maximum period of 42 years. If

33. *Manhattan Church of Christ Inc. v. 40 East 80 Apt. Corp.*, 2007 N.Y. Misc. LEXIS 6595; 238 N.Y.L.J. 54. Affirmed 2008 N.Y. App. Div. LEXIS 7820 (N.Y. App. Div. 1st Dep’t, Oct. 21, 2008).

34. *Plaza Hotel Assoc. v. Wellington Assoc.*, [1967] 55 Misc 2d 483, affd 28 AD2d 1209, affd 22 N.Y.2d 846.

35. *Basingstoke and Deane Borough Council v. Host Group Ltd.*, [1988] 1 WLR 348, 56 P&CR 31, 284 EG.

36. *United Equities v. Mandordic*, 8 A.D.2d 298 (1st Dept 1960), affd, N.Y.2d 911 (1960).

37. Harry K. Weiss, “Valuation of Land Under Long Term Leases,” *The Appraisal Journal* (October 1971): 520–525.

you project a higher use for the land, limit your appraisal to that stipulated period of time. This might influence your maximum value. Ask yourself, “How much would a builder or any other user of the land pay for it, faced with this time limitation [42 years]?”

As a practical matter, a lessee can only control a property for the term of the lease, including any extensions of the lease. Depending on how long the lessee can potentially maintain control of the property, reconstructing or replacing existing improvements to accommodate another use or the same use at a higher density in response to changing market conditions may not be financially feasible or allowed by the lease.

In highest and best use analysis, the level of rent flowing from a particular use is also impacted by the remaining term of the lease at the date of the rent review, as noted in the following two cases.

In *Wu et al. v. Interstate Consolidated Industries et al.*,³⁸ the tenants of a motion picture theater exercised the second of three 5-year options from 1986 to 1991. When the parties failed to reach agreement, three appraisers were appointed to determine the fair market rental value. On the basis of the potential highest and best use of the premises as retail shops, rent reflecting the average of the two closest appraisals was fixed at \$8,475 per month. Another appraisal by one of the two appraisers, along with the appraisal of the third appraiser, reflected an average rent of \$5,083.33 per month if the premises continued to be used as a theater. The lease restricted use of the premises to a theater, and the appeals court found that the purpose of a renewal option clause was to benefit the financial interests of the tenant by ensuring an opportunity to continue its business and recoup its investment. The court stated, “An interpretation that the rent during the option terms is to be based upon the highest and best use of the property despite the purposes for which lessor and lessee agreed it could be used, would be economically unreasonable and violate the intent of the parties.” The appeals court further expressed concern over the prospect of an ever-changing highest and

best use that the tenant could never exploit during the five-year period between each rent review:

ICI contends that to remain in the premises Wu must incur the substantial expense of converting the theater into a retail shopping center, an investment Wu may never recoup because in another five years ICI may conclude there is yet another highest and best use of the property....Such an option is in essence no option, is unreasonable, and could not have been the intent of the parties when they signed the lease.

Chancebutton Limited et al. v. Compass Services UK & Ireland Limited,³⁹ addresses the issue of whether an estimate of market rent at the rent review date should be based on the original term of a lease or the remaining term of a lease. The lessee contended that the term reflected the remaining term of 5 years at the date of the rent review, while the landlord contended that the hypothetical term was 25 years commencing on the relevant review date. In siding with the lessee, the court observed that, “The courts have consistently construed rent review clauses requiring that the hypothetical term be ‘equal to’ or ‘equivalent to’ the term of the actual lease as requiring that the rent be determined on the assumption that only the unexpired residue of the original term remains.”⁴⁰

Change in Zoning

A ground lease that is written to take into consideration any changes in zoning effected after the commencement of the lease can work to the benefit of either the landowner or the lessee when it comes time to reassess the rent, as noted in examples in *Commentary on Form of Ground Lease*:⁴¹

Example 1

In *Ruth*,⁴² the tenant, who leased property next to the Third Avenue elevated railroad, was required to build a 2-story building and to maintain the building in good condition. The tenant could not substantially alter the building without the landlord’s consent. At the time that the new rent (6% of the ‘full and fair value of the land...vacant and unimproved, in fee simple,...free of lease and unencumbered...’) was to be determined, the elevated railroad had been demolished and much

38. *Daniel Wu et al. v. Interstate Consolidated Industries et al.*, 226 Cal. App. 3d 1511; 277 Cal. Rptr. 546; 1991 Cal. App. LEXIS 58; 91. See *DBN North Beach, LLC v. John F. Debs et al.*, G039834, 2009 Cal. App. Unpb. LEXIS 127, decided in accordance with the ruling in *Wu*; the lessor’s appraisal, based upon a highest and best use as bare land suitable for a mixed-use residential and commercial project, was rejected in favor of lessee’s appraisal, reflecting the existing use of the property as a coffee shop, with the appeals court concluding that a market rental rate based on an unrestricted highest and best use would be “economically and commercially unreasonable and violate the intent of the parties.”

39. *Chancebutton Limited et al. v. Compass Services UK and Ireland Limited*, [2004] EWHC 1293 (Ch).

40. *Ritz Hotel (London) Limited v. Ritz Casino Limited* [1989] 2 EGLR 135; *Lynnthorpe Enterprises Limited v. Sidney Smith (Chelsea) Limited* [1990] 2 EGLR 131 (C.A.); *St. Martin’s Property Investments Limited v. CIB Properties Limited* [1999] L&TR 1 (C.A.).

41. Committee on Real Property Law and Ground Lease Subcommittee, *Commentary on Form of Ground Lease* (New York City Bar Association 2009), 25–26.

42. *Ruth v. S.Z.B. Corp.*, 2 Misc. 2d 631 [Sup Ct, NY County 1956], aff’d 2 AD2d 970 [1st Dept. 1956].

larger buildings could be constructed due to zoning changes. Accordingly, the value of the land, as limited by the lease restriction requiring the tenant to maintain a 2-story building, was considerably less than the value of the land unencumbered by the lease. The court determined that the valuation must be made without any consideration of the use restrictions contained in the lease because the lease expressly provided that the land was to be valued as if unencumbered by the lease. The rent was reset at a level which the lessee could not afford to pay, and the lessee defaulted on the ground lease and forfeited the improvements.

Example 2

In *New York Overnight Partners, L.P.*,⁴⁵ a ground lease provision called for a determination of the 'appraised value of the land.' The property had been zoned downward after the execution of the lease, in that the existing building, although a legal nonconforming use, was larger than could have been constructed under current zoning laws. The lease defined 'land' to specifically exclude improvements. The court held that the appraiser must determine the value of the land as though vacant, without improvements. The court also stated that although land value should ordinarily be appraised at its highest and best use, the fair market value must be determined with reference to any existing restrictions on the land, including the term of the lease and current zoning regulations. The court emphasized that because this lease clearly indicated that the value was to be determined as if the property was raw, vacant land, the beneficial impact on the value of the property of the existing nonconforming use could not be considered...

Appraisal Procedures

Appraisers should apply valuation procedures that are consistent with the overall objective of the rent review clause or as specifically directed by the language of the lease.⁴⁴ A combination of valuation inputs and procedures may be required, depending on the language of the rent review clause, the particular opinion of value being sought, and the quantity and quality of market data available. The selection of necessary valuation inputs may include, but are not limited to, the following items:

- land sales and land leases
- investor surveys
- land and land and building rates of return
- availability of mortgage financing
- leasing commissions
- appropriate units of comparison (floor area ratio, net rentable area, etc.)⁴⁵
- space/unit inventory and absorption
- land rents and building space rents
- operating costs
- construction costs
- mortgage financing costs
- tenant inducements
- appropriate measurement standards
- consumer price index or other indices

Appraisers enjoy broad discretion in deciding which factors are relevant to a particular valuation problem and how such factors impact the valuation, absent an agreement expressly requiring or precluding consideration of such factors.⁴⁶ While market value and market rent are well-defined by the appraisal profession, other types of value, not as clearly defined or described in a lease may require interpretation by the court.

Conclusion

Rent reset assignments can present appraisers with some of the most challenging and complex valuation work. However, as with every appraisal assignment, problem identification is the first step, and that necessitates a thorough reading of the ground lease. In common law jurisdictions, there has been a stream of precedents that make no distinction between land and building leases and land leases in recognizing the subsisting terms of a lease, including the remaining term, premised on a presumption of reality when

43. *New York Overnight Partners, L.P., v. Gordon*, 217 A.D.2d 20, 633 N.Y.S.2d 288 (1st Dept. 1995), aff'd 88 N.Y.2d 716, 649 N.Y.S.2d 928 (1996). The ground lease supported the Ritz-Carlton Hotel, a 152,000-square-foot structure, but by the time of rent adjustment the site had been down-zoned to permit only 82,500 square feet of buildable footage.

44. "[A]ppraisers are not limited to a single method of valuation unless the lease provides otherwise." "[T]he appraisers were free to use the market value method or the land residual method or any other reasonable method in assessing value." *Olympia & York 2 Broadway Co. v. Produce Exch. Realty Trust*, 93 AD2d 465, 468 [1983].

45. See *Chock Full O'Nuts Corp. v. NRP LLC* I 2007 NY Slip Op 09708 [47 AD3d 189]. "'The rents of comparable properties can provide a basis for estimating market rent for a subject property once they have been reduced to the same unit basis applied to the subject property. Comparable rents may be adjusted just as the transaction prices of comparable properties are adjusted in the sales comparison approach' (*Appraisal of Real Estate*, at 481 [11th ed.])" (*Matter of Saratoga Harness Racing v. Williams*, 91 NY2d 639, 644 [1998].)

46. "Appraisers have broad discretion in determining 'which of the myriad factors are relevant to a particular valuation and how such factors impact the valuation of the parcel of land, without interference or direction from the court,' absent an agreement expressly requiring or precluding consideration of such factors." *New York Overnight Partners v. Gordon*, 88 N.Y.2d 716, 721 [1996].

dealing with rent reset clauses. Of course, the parties to a lease are free to override a presumption of reality by including lease language to the contrary.⁴⁷

Highest and best use analysis, whether undertaken on an unrestricted or restricted basis, pursuant to the language of a lease, must consider supply and demand as part of the test of financial feasibility, which includes issues of mortgage financeability. The selection of appraisal procedures to be applied and the factors to be considered will depend entirely upon the opinion of value sought, whether market value, market rent, or some other defined or described opinion of value, pursuant to the rent review provisions of the lease. In those instances where the direction or meaning of the rent review clause is unclear, the courts may have to intervene and provide the necessary guidance.

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47. In *Canary Wharf Investments (Three) v. Telegraph Ltd.* [2003] EWHC 1575 (Ch), where the remaining term on the lease was only 15 years, the court held that "the term of the hypothetical lease...is to be a term of 25 years from the relevant rent review date..." At the time of the rent review, longer leases allowed prospective tenants to negotiate cheaper annual rents, thus resulting in an estimated saving to the tenant of approximately £7.5 million over the actual remaining term of 15 years.

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Web Connections

Internet resources suggested by the Y. T. and Louise Lee Lum Library

National Association of Realtors, Field Guide to Ground Leases

<http://www.realtor.org/library/library/fg410>

National Retail Properties Net Lease Exchange

<http://www.nnnex.com/>

NCREIF—database with valuation/lease data and transaction data

<http://www.ncreif.org/data.aspx>

Society of Industrial and Office Realtors

<http://www.sior.com>