

Long-Term Leases: Rent Reset Analysis

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Abstract

A provision for resetting rent is often found in long-term leases, with the objective being to periodically analyze the value attributed to the leased real estate. The property rights to be valued at each rent reset depend on the language of the lease, especially the rent reset clause. The lack of specificity associated with use of the term *market value* has led to questionable application of the term in rent resets. Inconsistent interpretations of a lease can lead to divergent opinions of value. Sometimes rent resetting provisions have no connection to the terms of the lease or the actual property rights; this may result in situations where it is difficult to apply conventional appraisal methods. This article summarizes and discusses a sample of rent reset cases and explores creative valuation solutions to rent reset valuation challenges.

Introduction

Rent reset clauses are typically found in long-term leases for land (unimproved or improved).¹ A lease is “a contract in which the rights to use and occupy land, space, or structures are transferred by the owner to another for a specified period of time in return for a specified rent.”² A lessee’s³ intended use of the leased premises, the time required for recovery or amortization of the capital invested in the business and leasehold improvements, and lender requirements for financing of leasehold improvements generally determine the length of the lease term.

The lease may provide for resetting the rent periodically during the term of the initial lease or when an option to extend or renew the lease has been exercised by the tenant. The basis for the

rent reset is dictated by the provisions of the lease, and the lease usually calls for arbitration if the landlord and tenant are unable to negotiate a new rent within a specified time frame.

A rent reset analysis for a land lease has the same objective as for a space lease—quantifying a new rent—unless the land lease *only* calls for a fee simple estimate of land value to which is applied an annual rate (percentage rate of return) as specified in the lease.⁴ The language of the lease, specifically the rent reset clause, and the market conditions prevailing at the time of the scheduled rent reset can have a profound impact on the rent to be paid by the tenant. Over time, a long-term lease may prove unfavorable to either the lessor or lessee, as noted by the appeals court in *Cook Associates, Inc. v. Utah School & Inst. Trust*:

1. A long-term lease is “[g]enerally a lease agreement extending for ten years or more....The terms and provisions of a long-term lease are set forth in detail in legally correct and complete form....[T]he tenant may desire, or be required, to do extensive remodeling or, if the property leased is land, to construct a building or other improvements.” Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 6th ed. (Chicago: Appraisal Institute, 2015), s.v. “long-term lease.”
2. *Dictionary of Real Estate Appraisal*, 6th ed., s.v. “lease.”
3. A lessee is “one who has the right to occupancy and use of the property of another for a period of time according to a lease agreement.” *Dictionary of Real Estate Appraisal*, 6th ed., s.v. “lessee.”
4. A fee simple estate is an “[a]bsolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat.” *Dictionary of Real Estate Appraisal*, 6th ed., s.v. “fee simple estate.” Also see discussion of property rights in Appraisal Institute, *The Appraisal of Real Estate*, 14th ed. (Chicago: Appraisal Institute, 2013), 3–7.

Long-term commercial leases, by their nature, are risky. Neither side can foretell future market conditions with any certainty. We presume that both [parties] bargained for the best terms and conditions each could get. Each party took the risk that unpredictable market forces would at some later day render the contractual terms unfavorable to themselves.⁵

The Rent Reset Clause

A lease that calls for an adjustment of rent during the life of the lease generally includes a procedure to be followed by the parties to the lease or the professional advisors identified and tasked with fixing the new rent.⁶ A rent reset clause can function to reset rent as an independent exercise or in relation to all or some of the subsisting clauses (provisions) in the lease itself.

Analyzing the adjusted or revised rent can be a contentious issue. Sometimes the rent reset clause is unclear or ambiguous as to the improvements (if any, and in what condition), property rights, methods, procedures, formulas, or factors that are to be taken into account—or disregarded—in estimating the revised rent. If the lease itself is to be disregarded, and the objective is to estimate the market value of the leased premises as if unencumbered, the rights to be valued are a fee simple interest.⁷ Conversely, if resetting the rent involves an analysis of a tenant's use and occupation, it is the rental value⁸ of the leased premises for the rent reset period that is to be estimated. In relation to these two mutually exclusive valuation exercises, the appellate court in *Bullock's Inc. v. Security-First National Bank of Los Angeles*⁹ drew a distinction between *market value* and *rental value*:

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.

In the *Bullock's* case, all that was required was a point-in-time estimate of the "appraised value of the land," exclusive of buildings and improvements, which the court found to mean fair market value. The appeals court did not define *market value* but relied on the term *market value* as referenced in the lease's repair and maintenance clause and the lease's condemnation clause.¹⁰ The court noted,

The parties have thus provided for a reduction in rent based upon the difference between the market value of the land before condemnation and the market value of what remained thereafter. And the reduction is calculated in the same manner as that provided for calculating rent—five per cent per annum of the predetermined amount. *Since the lease provides that a reduction in rent due to partial condemnation is to be measured by the drop in market value of the property covered by the lease, it may reasonably be inferred that the parties were thinking in terms of market value when they drafted the provisions of the lease relating to the calculation of rent.* [emphasis added]

Market Value and Property Rights

Definitions of *market value* often are silent as to what property rights are being valued. In his 2018 *Appraisal Journal* article, Sanders examines the evolution of *market value* definitions and the

5. 2010 UT App. 284, 243 P.3d 888 (2010), quoting *Oakwood Village LLC v. Albertsons, Inc.*, 2004 UT 101.

6. According to the ruling in *Rice v. Ritz Associates, Inc.*, 88 A.D.2d 513 (N.Y. App. Div. 1982), as long as the selected valuers prepare "the appraisal...in accordance with the procedures set out in the contract of the lease," the parties are bound by the result.

7. The interest to be appraised is an element of problem identification, and it is not necessary to consider this a hypothetical condition. See Stephanie Coleman, *Scope of Work*, 2nd ed. (Chicago: Appraisal Institute, 2016) and Appraisal Standards Board, *USPAP Frequently Asked Questions*, 2020–2021 ed. (Washington, DC: The Appraisal Foundation, 2020), FAQ 240, "Analyzing the Lease When Appraising Fee Simple Interest." If an appraiser chooses to premise such an assignment on a hypothetical condition, that would not be inaccurate, but it is unnecessary.

8. Rental value is derived by a rental comparison analysis employing quantitative or qualitative techniques, either separately or in combination, in accordance with the reset clause or use clause.

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

10. In condemnation, market value is based on a fee simple estate (undivided fee rule).

“varied conditions imposed on the hypothetical market” inherent in the numerous definitions of *market value*.¹¹ None of the various definitions of *market value* presented by Sanders explicitly considers property rights, with the exception of the following *market value* definition suggested by Marchitelli and Korpacz in their 1992 *Appraisal Journal* article:

The price in cash and/or other identified terms for which the *specified real property interest* is likely to sell as of the effective date of appraisal in the real estate marketplace under all conditions requisite to a fair sale.¹² [emphasis added]

Many definitions of *market value* emanate from eminent domain, where for state and federal purposes the *market value* of condemned land is determined based on the unencumbered, undivided fee, and disregards all other real property interests.¹³ Likewise, in most states the valuation of real property for assessment purposes denotes property rights in a fee simple type interest when there is more than one interest in a property.¹⁴ In these two areas of real property valuation, the value sought carries a presumption of undivided free and clear title, not burdened by an encumbrance such as a lease, and legislation to achieve this intended purpose overrides the contractual rights and obligations between a lessor and lessee.

When parties enter into a lease in the world of commerce, they agree to be bound by the terms and conditions of the lease. Even if a lease makes provision for resetting rent during the life of the lease, the lease remains in effect throughout the entire term, including any period covered by a lease extension or renewal option exercisable at the discretion of the tenant. In this situation, it may not be appropriate to assume that the

property is unencumbered by the lease at the time of the rent reset unless the rent reset clause manifests a clear intention to disregard the lease. At the end of the life of the lease, the leased premises revert to the landlord, and all tenant-owned leasehold improvements become the property of the landlord unless the tenant is obligated to remove the improvements under the terms of the lease.

The 1992 Marchitelli and Korpacz definition of *market value* as it relates to property rights is consistent with the current definition of *market value* in *The Dictionary of Real Estate Appraisal*, sixth edition, and in *The Appraisal of Real Estate*, fourteenth edition. The most widely accepted components of market value, including a reference to property rights, are incorporated into the definition:

The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the *specified property rights* should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.¹⁵ [emphasis added]

Directly related to the concept of market value is the identification of the specific property rights to be appraised. When references to “(fair) market value” appear in leases but the term is not adequately defined, it can cause uncertainty as to how the valuation analysis should proceed.

In the context of a lease involving the division of property rights between lessor and lessee, if the referenced market value does not specify the property rights to be taken into consideration, the analysis for resetting rent should generally be taken to include consideration of the lease itself.

11. Michael V. Sanders, “Market Value: What Does It Really Mean?” *The Appraisal Journal* (Summer 2018): 206.

12. Richard Marchitelli and Peter F. Korpacz, “Market Value: The Elusive Standard,” *The Appraisal Journal* (July 1992): 318.

13. “[W]hen property that is held in partial estates by multiple owners is condemned, the condemnor pays the fair market value of an undivided [fee simple] interest in the property rather than the fair market value of each owner’s partial interest.” [citation omitted] *Post No. 2874 VFW v. Redevelopment Auth.*, 2009 WI 84, 768 N.W. 2d 749.

14. “[A] division of ownership or the independent holding of separate legal interests in taxable property will not affect the mode of assessment. For instance, mortgagor and mortgagee interests, vendor and vendee interests, landlord and tenant interests, life tenant and remainder interests and cotenant interests are not separately assessed.” [citation omitted] “[T]he true value of...[real] property for assessment purposes is to be ascertained as if unencumbered by...a lease.” *People ex rel. Gale v. Tax Comm.*, 17 A.D.2d 225 (1962).

15. *Dictionary of Real Estate Appraisal*, 6th ed., s.v. “market value.”

Some misunderstandings as to the meaning of *market value* can be directly attributed to the misuse or commingling of terms related to market value. In appraisal literature, *market value* and *market rent* are not synonymous terms, but the parties to a lease are free to agree to their own valuation-related definitions.¹⁶ For example, in *Georg Jensen, Inc. v. 130 Prince Associates, LLC*,¹⁷ the lease made no distinction between *market value* and *market rent* in a rent reset involving a space lease; there the lease provided as follows:

Fair market value shall mean the current market rent for similar space within the general geographical area in which the building is located, assuming standard escalations with current base years, and all other relevant factors as determined by an independent M.A.I. Appraiser chosen by Landlord. [emphasis added]

Any disagreement as to the meaning of terms commonly found in appraisal literature and the lease must give way to the meaning ascribed to the terms in the lease:

[W]hen parties set down their agreement in a clear, complete document, their writing should as a rule be enforced according to its terms. Evidence outside the four corners of the document as to what was really intended but unstated or misstated is generally inadmissible to add to or vary the writing. That rule imparts “stability to commercial transactions....” Such consider-

ations are all the more compelling in the context of real property transactions, where commercial certainty is a paramount concern. [citation omitted]¹⁸

Title and Lease Restrictions

Restrictions or encumbrances identified in the abstract of title or the lease that have an impact on the property rights to be appraised, especially if an analysis of highest and best use is required,¹⁹ should be taken into account in resetting rent for the leased premises—unless the rent reset clause stipulates otherwise.²⁰ Premises leased as part of a complex (e.g., shopping center, office campus, industrial park) or as part of a building in a complex might also be impacted by covenants and restrictions of other tenancies.²¹

Freehold Premise

Analyzing the value of unencumbered land, or land assumed to be unencumbered, in fee simple as part of a two-step procedure in resetting rent requires an estimate of market value based on the highest and best use.²² Comparative analysis is the most common method of valuing property, provided sufficient and relevant market data are available. *Comparative analysis* is “the process by which a value indication is derived in the sales comparison approach. Comparative analysis may employ quantitative or qualitative techniques, either separately or in combination.”²³

16. “Courts therefore look to the definition of a term provided in the contract before considering how a dictionary defines the term.” [citation omitted] *Dannhouser, TD Co. v. TSG Reporting, Inc.*, 16cv00747 (S.D.N.Y. Jun. 21, 2019).

17. *Georg Jensen, Inc. v. 130 Prince Associates, LLC*, 2009 NY Slip Op 51483(U).

18. *Provident Loan Society of New York v. 190 East 72nd Corporation*, N.Y. Sup. 114915/2008.

19. In *New York Overnight Partners v. Gordon*, 649 N.Y.S. 2d 928, the court found that the appraiser “must take into consideration all restrictions including current zoning, and all encumbrances on the land, as well as the lease term.” See also discussion in Chapter 16, “Highest and Best Use Analysis,” in *The Appraisal of Real Estate*, 14th ed.

20. In *Ruth v. SZB Corp.*, 2 Misc. 2d 631, 636–637, *aff’d* 2 A.D.2d 970, “the court ruled that because the lease unambiguously provided that the land be valued ‘free of lease,’ the drafters could not have intended that the arbitrator ‘might give heed to the very lease which so declared’ otherwise and ruled that the land must be valued without considering the lease restrictions,” as cited in *Overnight Partners v. Gordon*.

21. For example, in *Oakwood Village LLC v. Albertsons, Inc.*, 2004 UT 101, 104 P.3d 1226 (2004), Albertsons at its own expense built a supermarket on a 42,800-square-foot plot under a long-term land lease with no use clause restriction in Oakwood Village shopping center, which consisted of twenty-six stores, with Albertsons as the anchor tenant. The lease restricted the landlord from leasing space in the shopping center to other supermarket tenants. After twenty-one years, Albertsons opened a supermarket as the anchor tenant in a new center across the street. Albertsons had no obligation to remain open and ceased operations in Oakwood Village while continuing to pay rent. Albertsons intentionally kept the old building vacant to restrict competition with its new store. As a consequence, occupants of three stores followed Albertsons to the new center, leaving four units vacant and causing a decline in sales of the remaining tenants in Oakwood Village.

22. A use or combination of uses found to be legally permissible, physically possible, financially feasible and maximally productive.

23. *Dictionary of Real Estate Appraisal*, 6th ed., s.v. “comparative analysis.”

After the market value of the leased premises has been estimated, the computation of rent is straightforward if the rent reset clause stipulates the interest rate (rate of return) to be applied to the market value of the subject property. If the rate of return is not stipulated in the rent reset clause, a second analysis is undertaken to determine the rate of return (i.e., annual rent) that a prospective purchaser expects to earn during the period covered by the rent reset (i.e., assumed holding period). The selection or development of an appropriate rate of return should reflect the prevailing rate in the marketplace, which may be accomplished by relying on primary data, secondary data, or both. Development of the rate of return may employ the following:

- Investment returns on sales of single-tenant properties leased on an absolute net (care-free) basis for a term consistent with the period covered by the rent reset.²⁴
- Investor surveys monitoring actual or expected rates of return.
- Government or private bond yields available for a term consistent with the period covered by the rent reset.
- Band of investment (weighted-average return on typical debt and equity components).²⁵

Leasehold Premise

Absent an express provision to the contrary, in the resetting of rent there is a presumption favoring valuation of leased premises as encumbered,²⁶ as is typical of leases that require an estimate of market rent or some other form of rent as described or

defined in the lease.²⁷ As noted by the court in *Klair v. Reese*, “In the rent setting context..., valuation of the land as encumbered by the lease is reasonable because the land will continue to be encumbered by the lease.”²⁸ The dissent in *No. 100 Sail Ventures Ltd. v. Janwest Equities Ltd.* made a similar observation, stating “[O]rdinarily a legally imposed restriction on the use of land is a factor to be taken into account in fixing its value, even as vacant and unimproved.”²⁹ In *United Equities v. Mardordic Realty Co.*,³⁰ the dissent noted that a lease may enhance or diminish the value of land:

Whether a lease for any term, short or long, increases or decreases the land value, as compared with its value if sold in fee simple, obviously depends on whether the landlord’s rights under the lease, particularly with respect to the right to receive rent, are valuable or not. A lease in which there is reserved a high rent will increase the land value. A lease in which the rent reserved is inadequate will decrease the land value, as compared with its value free and clear of any leasehold.

A lease’s rent reset provision may refer to “market rent.” According to *The Dictionary of Real Estate*, sixth edition, *market rent* is

The most probable rent that a property should bring in a competitive and open market reflecting the conditions and restrictions of a specified lease agreement, including the rental adjustment and revaluation, permitted uses, use restrictions, expense obligations, term, concessions, renewal and purchase options, and tenant improvements (TIs).

24. A capitalization rate based on first-year income in a stepped-up or stepped-down lease should be adjusted to reflect the average income or to reflect the change in the pattern of income during the term of the comparable lease. See David C. Lennhoff, “Direct Capitalization: It Might Be Simple But It Isn’t that Easy,” *The Appraisal Journal* (Winter 2011): 66–73.

25. *The Appraisal of Real Estate*, 14th ed., 495.

26. See *Hotel Plaza Associates v. Wellington Associates, Inc.*, N.Y.Supr., 55 Misc. 2d 483, 285 N.Y.S.2d 941 (1967), *aff’d*, N.Y.2d 846, 293 N.Y.S.2d 108, 239 N.E.2d 736 (1968), where “the appraisers erroneously valued the land at its highest and best use, as if it were vacant, without regard to the fact that the land was *encumbered by a lease*.” [emphasis added]

27. See Gary R. Menzies, “Choosing the Right Words: Interpreting Rent Review and Renewal Clauses in Commercial Leases,” *Alberta Law Review*, 34 Alta. L. Rev. 853 (1996), for a discussion of cases illustrative of *subjective* and *objective* approaches to fixing rent. An objective approach to rent reset is consistent with an analysis of “market rent,” whereas a subjective approach provides that rent for the review period or renewal term be “fair” or “reasonable” as between the landlord and the tenant “taking into account all factors which would affect the mind of the landlord and tenant.”

28. *Klair v. Reese*, 531 A.2d 219 (Del. 1987).

29. *No. 100 Sail Ventures Ltd. v. Janwest Equities Ltd.*, 1993 CanLII 477 (BC CA).

30. *United Equities v. Mardordic Realty Co.*, 8 A.D.2d 398, 187 N.Y.S.2d 714 (N.Y. Appellate Div., 1st Dept., 1959), *aff’d* 7 N.Y.2d 911 (N.Y. Court of Appeals, 1960).

If the lease provisions provide that the lease itself must be disregarded in resetting rent, this implies that the *unexpired term* of the lease—including any extensions or renewals—is to be disregarded as a constraint in any highest and best use analysis of the leased or “demised” premises. Examples of lease provisions on disregarding the lease in the rent reset valuation include the following:

- [Six percent 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*.³¹
- [A]n amount per annum equal to 6% of the fair market value...of the land constituting the demised premises, *considered as vacant, unimproved and unaffected by this lease*.³²
- Fair Market Rental is defined as “the annual rental for the demised lands which would be paid as between persons dealing in good faith and at arm’s length, *as if the demised lands were vacant, unencumbered and unimproved*.”³³
- The Annual Net Rental shall be...12% of the appraised value....Said appraisals shall be made...*as if the Leased Land were vacant, unencumbered, unimproved, and not under Lease*.³⁴
- The appraiser must regard the land “*as vacant, unimproved and unencumbered by this lease*.”³⁵
- The appraised value of the demised premises shall, in any event, be the value of the land exclusive of buildings or other improvements and *as if free and unencumbered during the year in which such value is to be established*.³⁶
- The market value of the demised premises shall be determined...in accordance with its highest and best use as if vacant land, exclusive of all or any improvements thereon, *without regard to the terms and conditions of the present lease* but considering as appropriate the impact of any legal impediments to a change of use created by zoning and other statutes and ordinances.³⁷

Physical and Legal Encumbrances

In the interpretation of a rent reset clause there is an important distinction between being instructed by a lease to ignore improvements of a physical nature that encumber land and being instructed to ignore encumbrances that affect title.³⁸ The first can be viewed as a physical encumbrance, while the second can be viewed as a legal encumbrance.

The California appellate court in *Evans v. Faught*,³⁹ addressed the issue of title encumbrances:

31. *Ruth v. SZB Corp.*, 2 Misc. 2d 631 (1956). The court noted that 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 provisions spell good or ill fortune for one party or the other.

32. *Manhattan Church of Christ, Inc. v. 40 East 80 Apartment Corporation*, 2007 NY Slip Op 32554(U).

33. *6524443 Canada Inc. v. City of Toronto*, 2016 ONSC 7147 (CanLII), upheld on appeal, *6524443 Canada Inc. v. Toronto*, 2017 ONCA 486 (CanLII).

34. *Funger v. Maizels*, 377 A.2d 70 – DC: Court of Appeals, 1977.

35. *Archdiocese of New York v. Amedeo Hotels Limited Partnership*, 295 A.D.2d 161 (2002), 742 N.Y.S.2d 635.

36. *Montreal Trust Co. v. Spendthrift Holdings Limited*, (22 March 1984), O.J. No. 296 (Ont. S.C. [unreported]).

37. *Humphries Investments, Inc. v. Walsh*, 202 Cal. App. 3d 766 (1988), 248 Cal. Rptr. 800. In this lease “ordinances and codes” were in reference “to the feasibility of any alternative use of the property and/or the likelihood of a future change in that status,” while not ruling out the existing mobile home park as the potential highest and best use of the demised premises.

38. In *Funger v. Maizels*, 377 A.2d 70 (D.C. 1977), the appeals court in interpreting part of the rent reset clause stated, “[t]he words ‘vacant’ and ‘unimproved’ have reference to the physical state of the property.”

39. 231 Cal. App. 2d 698 (1965). This case involves an unregistered lease of a portion of a ranch executed for a term of 25 years, with a lessee (County of Sonoma) right to renew the lease for an additional 25 years, and for the purpose of constructing and maintaining a powder magazine.

In *Shunk v. Fuller* and *Buetel v. American Mach. Co.* it was specifically held that a lease is an encumbrance upon the title to the property conveyed.⁴⁰ We hold, therefore, that an unrecorded lease which is binding upon a purchaser of real property is a limitation affecting title since it obviously is a right or interest in land which subsists in a third person to the diminution of the value of the land, but is consistent with the conveyance of the title.

The *Evans* court went on to characterize improvements on the subject property, consisting of an access road and the county powder magazine, as physical encumbrances unrelated to title:

[T]he powder magazine and the road, the presence of which put plaintiff on notice of the unrecorded lease, were also physical encumbrances upon the land which he was obliged to accept as burdens since plaintiff was presumed to have contracted to acquire the land subject to such physical burdens.

The *Evans* appeals court concluded that “the situation presented here is that the encumbrances under consideration are not such as affect only the physical condition of the land [i.e., access road and powder house], but its title as well [i.e., unregistered lease].”

Encumbrance by Lease

In *Standard Life Assurance Co.*⁴¹ the Ontario, Canada, appeals court refused to overturn a “final and binding” 1989 arbitration award as the decision was not “patently unreasonable,” even though “the arbitrators’ interpretation of the lease was wrong.” In a subsequent 2014 rent reset dispute, the court ruled that the reference to the arbitrators’ decision being “wrong” was made in passing and did not form part of the court’s ruling. The finding that the arbitration decision was not “patently wrong” rested on a point of distinction identified by the arbitrators in the language

of the rent reset clause in *Montreal Trust Company v. Spendthrift Holdings Limited*, which stated: “The value of the land exclusive of buildings or other improvements and as if free and unencumbered.”⁴² [emphasis added] In addition, the *Standard Life* court looked to the decision in *Ruth v. SZB Corporation* where the New York court had similarly stated, “[T]he full and fair value of the land demised which would sell for as one parcel considered as vacant and unimproved, in fee simple, by private contract, free of lease and unencumbered.”⁴³ [emphasis added] Therefore, it was not “patently wrong” for the arbitration panel in *Standard Life* to conclude that

[I]t is possible for landlords and tenants to draft documents which would require them to ignore some aspects of market reality existing as of the valuation date. However, we do not find that the document we have before us [which makes no reference to ignoring encumbrances] is such a document in relation to relevant legislation.

At the time of the 1989 rent reset, the rental apartment building was subject to rent control legislation, which prevented rents from rising to market levels. For the subject apartment building, residential condominium development represented the highest and best use of the property, a use not permitted on leased land in the Province of Ontario on the date of the rent reset. As a result, the arbitrators fixed the market value of the land at \$4,250,000, based on a (restricted) highest and best use as a rental apartment development, resetting the rent at \$286,875 per year for a period of 25 years, applying the prescribed rate of 6.75%. On the basis of residential condominium development, the market value of the freehold interest in the land was \$13,500,000, which at the prescribed rate of 6.75% would have generated annual rent of \$911,250. Therefore, from the lessor’s per-

40. By way of analogy, the following have been held to be encumbrances affecting title: building restrictions (*Whelan v. Rossiter*, 1 Cal. App. 701, 704, 82 P. 1082; *Tandy v. Waesch*, 154 Cal. 108, 97 P. 69; *Bertola v. Allred*, 46 Cal. App. 593, 189 P. 489); reservations for rights-of-way for water pipes and ditches (*Tandy*, supra); easement for a pipeline (*Krotzer v. Clark*, 178 Cal. 736, 739, 174 P. 657); and pendency of condemnation action (*Hunt v. Inner Harbor Land Co.*, 61 Cal. App. 271, 272, 214 P. 998).

41. *Standard Life Assurance Co. v. Parc-IX Ltd.* (Div. Ct.), 1991 CanLII 7350 (ON SC). In the *Standard Life Assurance* case, the rent reset clause called for “the greater of \$40,500 and ‘land market rent’ defined as ‘a sum equal to 6 3/4% of the fair market value of the property as if it were unimproved.’” [emphasis added]

42. *Montreal Trust Co. v. Spendthrift Holdings Limited*, 42 [1984] O.J. No. 296 (H.C.).

43. *Ruth v. SZB Corp.* (1956), 153 N.Y.S. 2d 163 (N.Y. Sup. Ct.), *aff’d* (1956), 158 N.Y.S. 2d 754 (N.Y. Sup. Ct. – App. Div.).

spective, the annual rental loss was found to be \$624,375 (\$911,250 – \$286,875), and the undiscounted loss of rent over the 25-year period amounted to \$15,609,375.⁴⁴ Discounted at 6.75%, the present value of the lessor's annual rental loss of \$624,375 was \$7,443,056 ($\$624,375 \times 11.920811$).

The first 25-year reset period expired in 2014. Again, the parties failed to reach agreement on how the property should be valued. In advance of the second round of arbitration, the parties sought a declaration from the court as to whether the term *land market value* “should be interpreted to include the highest and best possible use of the land, as if the Property were unimproved and unencumbered, including the value of the Property as if it were available for freehold condominium development as of the valuation date [March 15, 2014].” The court concluded that the interpretation of the rent reset clause “is governed by the 1990 Arbitration Decision, and [lessor] Manulife is estopped from relitigating it.”⁴⁵ As part of the analysis, the court examined a number of prior rent reset rulings interpreting “fair market value of the property as if it were unimproved” to mean not only ignoring the improvements but that “the parties also intended to disregard encumbrances impacting the value of the land.” Commenting on the distinction between *encumbrances* and *improvements*, the court stated as follows:

For reasons of which I am uncertain, both the Court of Appeal in Royal Trust and the Divisional Court in Standard Life inserted the word “unencumbered” into the equation so that in both decisions the fair market value was based on a notional value of the land that was not only unimproved, but also unencumbered. I cannot locate any explanation in the case law as to how or why this occurred. [emphasis added]

In *Roywood and Gardenview [Royal Trust]* the Court of Appeal held that words such as “unimproved” or “without buildings or improvements” included “unencumbered.” I am bound by those decisions even if I have some difficulty understanding them. In my opinion an encumbrance is a legal interest in the land that diminishes its value as opposed to physical buildings placed upon the land or physical improvements made to the land. In any event the present leases do not use any of the words unencumbered or vacant or unimproved, they merely refer to the lands.⁴⁶

The court also concluded that the terms *unimproved* and *unencumbered* mean two different things. It noted that *Black's Law Dictionary*, sixth edition, defines *improvement* in terms of physical modification:

A valuable addition made to property (usually real estate) or an amelioration in its condition, amounting to more than mere repairs or replacement, costing labor or capital, and intended to enhance its value, beauty or utility or to adapt it for new or further purposes. *Generally has reference to buildings, but may also include any permanent structure or other development, such as a street, sidewalks, sewers, utilities, etc. [emphasis added]*

On the other hand, *Black's* defines *encumbrance* as a legal interest: “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.” Accordingly, the court concluded that “a property can be unimproved yet encumbered. Conversely, it may be improved and unencumbered. The two words are not synonymous.”

In *Selective 901 Truman, LLC v. Goodrich & Hops Properties West*,⁴⁷ the lessor and lessee were unable to agree on the “fair rental value” in a rent reset of a long-term land lease. The lease commenced January 1, 1958, for a term of 53 years,

44. The ground lease is for a term of 99 years from March 15, 1964, and the first rent reset was for 25 years from March 15, 1989, with the next rent reset scheduled for March 15, 2014. Amendments in 1998 to the *Condominium Act* permit leasehold condominiums provided the term of the lease is at least 40 years.

45. *Manufacturers Life Insurance Co. v. Parc-IX Limited*, 2018 ONSC 3625. In 1964, Standard Life acquired Royal Trust Company's interest in the property. In 2015, the property was transferred from Standard Life to Manulife.

46. The judge concluded he was no longer bound by the ruling of the Court of Appeal in *Royal Trust* in light of the later Supreme Court of Canada ruling in *Musqueam Indian Band v. Glass*, 2000 SCC 52 (CanLII), [2000] 2 S.C.R. 633 and the Court of Appeal ruling in *Board of Regents of Victoria University v. G.E. Canada Real Estate Equity*, 2016 ONCA 646 (CanLII), 2016 CarswellOnt 13524, leave to appeal refused, 2017 CarswellOnt 3571 (S.C.C.).

47. Cal Court of Appeal, 2nd Appellate Dist., 3rd Div., 2019.

allowing for extensions up to 99 years. The leased premises consisted of 1.94 acres. In 1962, the lessee built a 34,000-square-foot strip center with paved surface parking. The lessor triggered a rent reset for a 10-year period, effective March 1, 2015, with a total of 43 years remaining on the lease. The lease's rent reset and use clauses stated in relevant part:

At any time or times after ten (10) years from the effective date of this lease such rental may be revised by [Lessor] giving thirty (30) days' advance notice in writing to Lessee. *Fair rental value of the leased premises shall be determined without consideration being given to the effect in such values of the improvements of Lessee and in accordance with approved appraisal practices.* This land shall be valued at the time of such revision as determined by [Lessor] and Lessee, but rental thereon should not be less than the minimum rental rate hereinbefore set forth, nor more than six percent (6%) per annum of the then appraised value of the land. When so revised, such rental shall not be subject again to revision until ten (10) years from the effective date of such revision. [emphasis added]

Said premises shall be used by Lessee solely and exclusively for erection, maintenance and operation of office buildings, buildings for general commercial and manufacturing uses, parking lots which shall include a subterranean parking lot if deemed necessary, and heliport roof deck. ...Lessee agrees to comply with all applicable laws and regulations with respect to the use of the leased premises.

The parties failed to reach agreement as to the fair rental value for the 10-year period, and the rental dispute proceeded to arbitration. The arbitrator determined that "fair rental value has essentially the same definition as fair market value, both leading to assumptions that a buyer is knowledgeable and under no compulsion to buy (or lease), and a seller is otherwise willing to sell (or lease) under no compulsion to do so."

The central issue was whether the appraisals were required to give consideration to the effect of encumbrances on the property, which is burdened by the lease itself for a remaining term of 43 years.

The arbitrator noted the lease dictated that the appraisals be prepared "in accordance with approved appraisal practices."⁴⁸ The arbitrator also noted the lease was not ambiguous and that "the Subject Property must be appraised assuming encumbrances." The lessor's appraisal treated the leased premises as if unencumbered by the lease and valued the land in its "highest and best use" at \$5.5 million. One of the lessee's appraisals took into account the impact of the unexpired lease term of 43 years and valued the land at \$1,387,000. Both appraisals, as well as a second appraisal prepared on behalf of the lessee, were rejected by the arbitrator. The lessor's appraisal was rejected as it failed to account for the impact of the ground lease, which places a burden on the property and lowers its value because of the lease's 43 remaining years with all the restrictions on use and remaining lease resettings. The lessee's appraisals were rejected as being too low.

Instead, the arbitrator turned his attention to the actual sale of the subject property at \$3,425,000 (all cash) in December 2014, encumbered by the ground lease, which the lessee had characterized as "the perfect comparable." The arbitrator noted that the subject property had been extensively marketed for sale on the open market by a sophisticated brokerage firm. He concluded that the transaction offered the best evidence of the value of the land, as if unimproved, but encumbered by the ground lease. On the basis of the \$3,425,000 sale price, the arbitrator fixed the rental value of the leased premises at \$205,500 annually by applying a rate of 6%, as allowed by the lease.

The lessor sought to have the arbitrator's award vacated, contending,

1. The award was "untethered" from the evidence, which called for "fair rental value" to be determined by appraisals (all rejected by the arbitrator), inappropriately taking into account the long-term ground lease, and
2. Application of an improper method, i.e., the recent purchase price of the subject property as the foundation for fixing the "fair rental value."⁴⁹

48. In the award, the arbitrator pointed to Standards Rule 1-4(d) of the Uniform Standards of Professional Appraisal Practice (USPAP), which provides "an appraiser must analyze the effect on value, if any, of the terms and conditions of the lease(s)."

49. Standards Rule 1-5 of USPAP requires an appraiser to "(a) analyze all agreements of sale, validated offers or third-party offers to sell, options, and listings of the subject property current as of the effective date of the appraisal if warranted by the intended use of the appraisal; and (b) analyze all prior sales of the subject property that occurred within a reasonable and applicable time period if relevant given the intended use of the appraisal and property type."

The lessor also objected to the inclusion of instructive language in the award that purported to guide all future rent resets; the language provided,

Future rent resettings shall be determined by appraisal of the Subject Property as encumbered by the Lease terms, including the remaining time on the Lease and any restrictions on use contained in the Lease or by conditions and restrictions imposed by the city of San Fernando. [Emphasis added by court.]

The trial court rejected the lessor's motion to vacate the award, a ruling upheld by the appellate court, finding that the arbitrator acted within his authority in rejecting the appraisal evidence and instead relying on the sale of the subject property. The court also found that the inclusion in the award of an instruction to take into account the lease itself in future rent resets was consistent with the arbitrator's mandate.

To analyze the situation, keep in mind that the December 2014 acquisition of the subject property is a leased fee interest, which includes both the value of the anticipated rent during the remaining term of the lease and the value of the reversionary interest upon expiry of the lease.⁵⁰ Accordingly, the purchase price of \$3,425,000 does not isolate and measure the value of the land as a 43-year holding, consistent with the remaining term of the lease. In other words, the value of the land is overstated by the present value of the reversionary interest in the land.

- Accepting the lessor's appraised freehold value of \$5,500,000, deferred 43 years, and discounted at, say, 6%, results in a present value of \$448,963 ($\$5,500,000 \times 0.08163$). Deducting the \$448,963 from the purchase price of \$3,425,000 (leased fee interest) results in a market value (capital value) of the land (lease) held for a term of 43 years of \$2,976,037 ($\$3,425,000 - \$448,963$).⁵¹

- Applying a rate of 6% to the \$2,976,037 suggests a fair rental value of \$178,562 per annum, fixed for 10 years.

Market Value of Land Assumed Unimproved for Lease Term

In *United Equities*,⁵² the majority opinion of the New York appeals court stated that "the land should be appraised for the best use that it can be put to, and not only for the [current] use," with the formula for computing rent being "a sum equal to six per cent of the fair market value of the land." [emphasis added]. The court also ruled that the 21-year renewal term of the lease and a further 21-year renewal option had to be taken into account in the highest and best use analysis of the land; the court stated, "The only limitation upon [market] value, if any, is the number of years [42] the most advantageous use of the land can be enjoyed under the lease."

The appeals court offered no guidance as to how the market value (capital value) of such a 42-year landholding should be determined, leaving the matter to the discretion of the appraisers. Presumably, a prepaid ground lease or purchase of a ground lease with an equivalent term of 42 years and a similar highest and best use would reflect the market value of the subject land, provided such market data is readily available.⁵³ Alternatively, it may be possible to conduct some form of ratio analysis, comparing the value of the land as a 42-year holding to the freehold value of the same land held in perpetuity. Of course, the difficulty of financing a 42-year landholding would also have to be factored into any ratio analysis. Assuming a freehold acquisition is equivalent to capitalizing \$1 per annum in perpetuity at 6%, it is possible to express the value of a fixed-term holding as a ratio or percentage of value in perpetuity.

50. The arbitrator did observe, however, that "[t]he land will become more valuable in the future and at every resetting. The encumbrance [lease] on the land will lessen due to the remaining years [shorter unexpired term at every rent reset] under the Lease," thereby, enhancing the value of the lessor's reversionary interest.

51. The market value of the land held for 43 years is 54.1% of the market value of the same land held in perpetuity ($\$2,976,037 \div \$5,500,000 = 0.5411$ or 54.11%).

52. *United Equities v. Mardordic Realty Co.*, 8 AD.2d 398, 187 N.Y.S.2d 714 (N.Y. App. Div., 1st Dept., 1959), *aff'd* N.Y.2d 911 (N.Y. Court of Appeals, 1960).

53. For example, the City of Vancouver in September 2018 estimated the freehold value of a mixed-use site at \$8,500,000, and the 60-year lease was priced at 75% (\$6,375,000) of the freehold value, with ground rent payments calculated on this figure. (Administrative Report, August 21, 2018.) A 40-year ground lease is priced at 60% of the freehold value. (Administrative Report, January 30, 2017.)

- Capitalizing Year-1 income at, say, 6%, results in a factor of 16.667 ($1 \div 0.06$).⁵⁴ A 42-year holding at the same rate, compared to a perpetual ownership, results in a factor of 15.225, and indicates a capital value equivalent to 91.35% ($15.225 \div 16.667$) of the freehold value,⁵⁵ before considering a further adjustment for constraints associated with financing a 42-year landholding.
- Loading the capitalization rate by, say, 150 basis points to 7.5%, to reflect financing constraints, the present value factor of 1 per annum at 7.5% for 42 years is 12.694, and represents 76.16% of the freehold value (perpetual ownership) of one per annum in perpetuity at 6% ($12.694 \div 16.667$).

The ratio analysis is rate sensitive, and the value estimate will vary with the rates selected. Other creative solutions could be explored, as there is no textbook solution to this type of appraisal problem.

Conclusion

An examination of the title abstract and a thorough reading of an executed copy of the lease—including any schedules and amendments, paying particular attention to the rent reset clause—are essential to an understanding of how rent should be reset and what factors should be taken into account or disregarded in the context of the specified or identified property rights.

As a general rule, a rent reset clause that calls for an estimate of market rent or some other form

of rent will take into account the subsisting terms and conditions of the lease, unless the rent reset clause manifests a contrary intension. When addressing a rent reset for an option to extend or renew a lease, courts have generally ruled that the option is for the benefit of the tenant, and that the new rent should reflect continuation of the existing use, as contemplated by the *use* clause in the original lease.⁵⁶

If the lease itself must be considered at the rent reset date, the remaining life of the lease in concert with the use clause and prevailing market conditions can constrain highest and best use analysis and, in turn, the amount of rent for the leased premises if the lease itself must be considered. Permissive or expansive use clauses allowing for “any lawful use” tend to result in higher rents than for specific use clauses, all other things being equal. Any leasehold improvements remaining in the leased premises at the end of the life of the lease become the property of the landlord unless the lease instructs the tenant to remove the leasehold improvements.

A highest and best use that forms the foundation for a rent adjustment and stems from a rent reset clause that assumes leased premises are unimproved and unencumbered (contrary to the actual physical state and legal status of the leased premises) may cause the lessee financial hardship.⁵⁷ The present leasehold improvements may not generate rent sufficient to support rent determined on the basis of highest and best use in fee simple, and the remaining lease term or the subsisting terms and conditions of the lease may preclude the lessee from achieving the (unrestricted) highest and best use.⁵⁸

54. A 99-year holding of one per annum discounted at 6% accounts for approximately 97% ($16.615 \div 16.667$) of a holding in perpetuity at the same rate.

55. See Kwek Sian Choo and Dionne Hoh, *Determining the Value of Leasehold Land: A Closer Look at “Bala’s Table”* (Singapore: Centre for Liveable Cities, 2017), available at <http://bit.ly/389efdN>.

56. In *DBN North Beach, LLC v. Debs*, the California Court of Appeal (4th Appellate Dist., 3rd Div., 2009) acknowledged that during the first 10 years of a 20-year lease extension “[t]he terms of the lease and common sense indicate that a resetting of the lease amount is to be according to ‘fair market rental value’ of the property... as contemplated by the lease [use clause], not as bare land [unencumbered by the lease], on a ‘highest and best use’ basis, as a mixed-use residential and commercial project.” It 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 and commercially unreasonable and violate the intent of the parties.”

57. The courts have held that “economic hardship is not a reason to rewrite a lease made between two sophisticated commercial entities.” *853 Seventh Ave. Owners, LLC v. W & HM Realty Co., LLC*, 2005 N.Y. Slip Op. 03770 [18 A.D.3d 241] May 10, 2005.

58. See *Ruth v. SZB Corp.*, (1956) 153 N.Y.S.2d 163 (N.Y. Sup. Ct.), *aff’d* (1956), 158 N.Y.S.2d 754 (N.Y. Sup. Ct., App. Div.), stating, “land to be valued in accordance with the [rent reset] formula of the underlying lease [in highest and best use], without treating as an element of value the restrictions on [use and] user flowing from the lease.”

When the objective of a rent reset clause is to estimate market value, it is generally in the context of the fee simple interest in the leased premises consisting of unimproved and unencumbered land. If the rent reset clause instructs the appraiser to ignore the lease itself, it is inappropriate to reset rent for the leased premises selecting only favorable lease terms and covenants, and vice versa, as the lease cannot be disregarded and embraced simultaneously.

About the Author

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Additional Resources

Suggested by the Y. T. and Louise Lee Lum Library

Appraisal Institute

- **Education**—*Advanced Market Analysis and Highest and Best Use*
<https://www.appraisalinstitute.org/education/>
- **Lum Library External Resources Knowledge Base [Login required]**
 - Information Files—Land
 - Information Files—Property rights
 - Information Files—Value
- **Practice Standards and Guide Notes**
<https://www.appraisalinstitute.org/professional-practice/>
- **Publications**
<https://www.appraisalinstitute.org/store/>
 - *The Appraisal of Real Estate*
 - *Market Analysis for Real Estate*, second edition

Calkain—Lease-related reports

<https://www.calkain.com/research/>

CCIM Site to Do Business

<https://www.stdb.com>

National Association of Realtors—Research and statistics

<https://www.nar.realtor/research-and-statistics>

National Real Estate Investor

<https://www.nreionline.com>

NCREIF—Commercial data resources and research

<https://www.ncreif.org/>

Society of Industrial and Office Realtors—Transactions and data

<https://sior.com/transactions-and-data/transactions>

US Department of Transportation, Federal Highway Administration—Realty

https://www.fhwa.dot.gov/real_estate/index.cfm