

Are Ground Lease Rent Reset Clauses Formulas for Disaster?

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A common deal structure for many development projects in the United States can include subtle time bombs—in the form of rent reset formulas—that can explode many decades later.

FOR EXAMPLE, IF THE GROUND RENT will adjust based on some appraisal in 20 or 30 years, exactly what will that appraisal cover? Even as early as the term sheet, anyone who negotiates a ground lease must focus on this issue and steer clear of many possible landmines.

A ground lease “rent reset” clause starts from a fairly simple proposition: every few decades, the rent should adjust to reflect changes in the real estate market. At the time of the initial closing, the parties cannot predict values 20 or 30 years out. Therefore, the formula somehow needs to reflect the market value—at the time of the rent reset—of whatever the landlord delivered to the transaction.

A typical formula will look at the value of the leased land at the time of adjustment, then multiply it by either a fixed percentage (6 to 7 percent for today’s ground leases) or a percentage that depends on the interest rate environment at the time. The result is the new annual ground rent. Until that date, the rent might rise by formulaic “bumps” every few years. These bumps rarely cause issues, because the issues arise only when the rent somehow “goes to market.”

As the first problem area, will the adjusted rent consider just the value of the land? Or will it also reflect the value of whatever buildings the developer/tenant has built on it?

Usually, the parties sign a ground lease before the developer builds the project. Therefore, the rent *should* compensate the landlord only for the value of the land, not the project. This should remain true at every rent reset.

In some cases, though, the rent reset clause will reflect the appraised value of the “premises” or the “property,” without carefully indicating whether this means just the land, or also the building. Words like these can easily *sound* right but turn out wrong, particularly if the lease does not include and consistently use a clear and intuitive set of defined terms.

If the rent reset formula includes any vagueness at all on the rather basic question of land versus building, the landlord will argue that the adjusted rent should consider the value of the building as well as the land. If the landlord wins that discussion, then the value of the tenant’s position under the ground lease can drop to zero. The value of the landlord’s position will rise accordingly.

If the rent reset clause simply requires a revaluation of the land, can the parties stop thinking? Not necessarily.

What does the value of “the land” mean? Lease negotiators sometimes say the land value should reflect the fact that the land will be subject to the lease. This can require an appraiser to figure out how the existence of the lease impairs land value—a determination that cannot be made without knowing the rent under the lease—but the rent under the lease cannot be known without knowing the value of the land. So the analysis becomes circular and ultimately impossible.



BAT PHOTOS

As a better formulation, leases should require valuation of the land without regard to the lease, as if the land were vacant and unencumbered, i.e., the lease did not exist. These words try to describe the site as it existed—both physically and legally—when the landlord first delivered it to the tenant.

Landlords and tenants also need to think about a handful of events that can change the value of hypothetical vacant land between their lease closing and the time they need to redetermine their rent. For each such event, should the “land value” rise? Or should it ignore the particular event?

Each possible event may sound like a surprise out of left field. But surprises do happen, particularly over the time spans covered by rent reset clauses in ground leases. This, of course, does not even cover every real estate lawyer's favorite, the possibility of casualty or condemnation.

As one common example, what if the zoning of the land changes by the time of the rent reset?

An "upzoning" could allow for a larger building on the site, or a wider range of permitted uses. Either way, at the time of the rent reset, the tenant might not be able to exploit the upzoning—for example, because the tenant cannot economically alter its building, and demolition might not make sense.

In that case, if the rent reset formula takes into account the upzoning, the tenant will overpay for the value it receives under the ground lease. After the rent reset, the project could become uneconomic. The rent formula would destroy value.

Downzonings create comparable issues—in this case, mostly for the landlord.

Ground leases should try as much as possible to replicate circumstances as they existed on the date of signing, except to the extent that changes have actually helped or hurt both parties. For example, if the tenant actually did—or reasonably can—take advantage of an upzoning, then the rent reset should probably consider it. Otherwise, the formula would simply consider the zoning as it existed at signing.

The actions of the parties can sometimes change land value in other ways. The parties may be able to move transferable development rights—the right to build a particular amount of space—to or from the land. If the tenant acquired such rights from another site, they would increase the value of the hypothetical land for any rent reset. If the landlord did not pay for those rights, though, the landlord should probably not benefit from the incremental value.

What if the tenant combined this site with an adjacent site, so that the combined site was worth more than the sum of its parts? The landlord may want the land value to include some "equitable allocation" of that incremental "assemblage value." The tenant would, of course, feel otherwise.

Either way, the parties' rent revaluation formula should clearly include or not include any assemblage value.

The site may turn out to have other special characteristics that either party may want the valuation formula to consider or ignore. For example, if the site qualifies for tax abatements or deferrals, this may enhance the hypothetical "land value." It may also increase or decrease based on qualification for various forms of bond financing or subsidy programs.

Should the rent reset clause consider any characteristics of the land like these? What if the tenant was the party that obtained and qualified for the special tax benefits or other qualification? Why should the landlord obtain any benefit in the form of higher land value and hence higher rent? On the other hand, what if the tenant needed and got the landlord's cooperation to qualify?

Instead of arguing about these questions in court when the parties actually need to read and interpret their rent reset clause, they should negotiate and resolve them in the lease itself, as part of their business deal regarding the future rent. These are not mere legal issues to be left to the lawyers.

Finally, even if the tenant generally likes the "land value" definition in the lease, the tenant still needs to think about another set of issues. The tenant needs to recognize that when an appraiser tries to determine the value of vacant land, the appraiser will assume the land can be used for its "highest and best use"—essentially, the most profitable use to which the land could reasonably be put at the time of appraisal.

If the "use" clause in the lease gives the tenant enough flexibility to put the land to its highest and best use, then the valuation formula makes sense. The tenant will pay for a full range of possible uses, and the lease will allow them.

When the parties actually reset their rent, though, the tenant will actually be operating only one or more particular uses, and might argue that the revaluation should assume only that the land could be used for whatever uses the tenant is actually operating. Typically, over the long term of a ground lease, and in negotiating the document at the outset, the landlord will have the better of this argument.

On the other hand, if the lease limits the tenant's use of the leased premises, or imposes burdens or restrictions that would not encumber a hypothetical buyer of vacant land, then the tenant may want the "land value" for the rent reset to take those restrictions and burdens into account.

Otherwise, the rent reset formula could require the tenant to pay for the right to operate a particular use that the tenant might not actually be able to operate—so the tenant would pay for value that the lease did not deliver.

Beyond these concerns, any particular transaction may raise its own issues that a rent reset clause should either take into account or exclude. Looking ahead, a landlord and a tenant need to think about what they really mean by *land value*, and try to foresee the arguments that either side might make in determining its meaning.

By having that discussion in their lease negotiations, with advice from competent real estate counsel and an appraiser, the parties can avoid a much more expensive discussion in court when the rent reset clause activates—with great pain—a few decades later. They also spare themselves the intervening risks and headaches, not to mention the loss of marketability and financeability, that uncertain or unfavorable future rent reset clauses can create. **UL**

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