The Problem of Ground Leases

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Abstract

Recent dramatic ground rent reappraisals of office buildings in Midtown Manhattan in New York City have caused many leasehold mortgage lenders to avoid financing ground leases with any sort of reappraisal provisions. The issue often turns on whether the land underlying the project is to be valued at its highest and best use as if vacant and unencumbered, or as presently improved and used, an issue with a long history in rent reset reappraisal proceedings. Inflation indexing and "modern" ground leases have been proposed to replace traditional ground lease structures, with limited success. Some version of rent resets utilizing "use valuation" might satisfy financing concerns in new ground leases.

Recently, there have been some dramatic reappraisals of Manhattan ground-leased properties that have upset traditional ground lease markets. As a result, many leasehold mortgage lenders, which are essential to the financing of ground-leased properties, are avoiding leases with reappraisal clauses. This is affecting the negotiation, financing, and economics of projects in New York and throughout the country and threatens to bring an end to traditional ground lease practice.

The types of issues that have arisen with ground lease reappraisals can be illustrated in the following cases involving Midtown Manhattan landmark office buildings.

Lever House. A January 1, 2017, article in *Crain's New York Business* led with the statement "building owners are facing huge rent increases as ground lease resets loom." The article goes on to explain "the issue is the fine print in [ground] leases that allow landowners to jack up the prices as city land values continue to soar…[due to] ambiguous language that allows rent increases to be calculated based on the value of a property as if it were 'unimproved and unencumbered'—essentially a vacant parcel of land."[1] This situation can be seen in the circumstances of Lever House, a twenty-one-story landmark office building at 390 Park Avenue, built on a ground lease in the 1950s. A reappraisal proceeding threatened an increase in the ground rent from $6.15 million to more than $20 million in 2023, more than the entire net income produced by the property. As a result of the looming ground rent increase, the then-ground-lease tenant was unable to refinance the existing leasehold mortgage. The mortgage, in default, was sold at a reported $68.3 million loss.[2] A new tenant emerged with a new ground lease in 2020.[3]

Chrysler Building. The iconic art deco Chrysler Building has towered over Manhattan since the 1930s, built on land owned by the Cooper Union school. Following a loan default by the ground lease tenant in the 1990s, the school and a successor tenant entered a new 150-year lease that included "a rent clause prevalent in New York City that allows for a market-based reset."[4] In 2008, the tenant sold a 90% interest in the lease-

1. Daniel Geiger, "Ground Wars: Surging Property Values Are Upending Commercial Landlords' Ground Leases," *Crain's New York Business*, January 1, 2017, updated January 3, 2017.
2. Lois Weiss, "Park Avenue's Lever House CMBS Loan Lost $68.3M: Report," *New York Post*, February 19, 2019.
3. Lois Weiss, "Aby Rosen Hands Over Lever House to Tod Waterman and Brookfield," *The Real Deal*, May 27, 2020, https://bit.ly/3tEsTtp.
4. Kurt Pollem, Steve Jellinek, and Erin Stafford, *Ground Leases and Leasehold Interests in CMBS: When the Value of the Parts Doesn't Equal the Whole*, DBRS Morningstar Commentary, February 10, 2021, https://bit.ly/4aK4wve.

hold to an investment fund for $800 million.[5] In 2018, the ground lease reset provision resulted in an increase in the annual ground rent from $7.5 million to $32.5 million, with additional increases reportedly set for 2028 and 2038.[6] In 2019, the tenant and the investment fund sold 100% of the leasehold to a new buyer for $150 million, an enormous loss for the fund.[7] (Apparently, there was no material leasehold mortgage.) The new buyer attempted to renegotiate the ground lease in 2020 and 2021, but no lease revisions have been reported.[8]

More recently, reports cite a complicated legal battle over a rent reset involving the landowner and a real estate investment trust that owns the office building at 625 Madison Avenue, after an arbitrator ordered an annual ground rent increase from $4.6 million to $20.25 million.[9] Another dispute has involved One Penn Plaza at 330 West 34th Street, where a reappraisal was expected to increase the annual rent from $2.5 million to more than $25 million.[10]

Reset Appraisal Practice

Some versions of the troublesome rent reset reappraisal clauses have been included in ground leases since at least the 1930s. In the seminal New York case *Ruth v. S.Z.B. Corp.*,[11] a clause appeared in a 1935 lease providing for renewal rent equal to 6% of "the full and fair value of the land demised which the same would sell for as one parcel considered as vacant and unimproved, in fee simple, by private contract, free of lease and unencumbered."[12] In the ground lease, the critical elements for the reappraisal are "vacant and unimproved," "unencumbered," and "free of this lease." Most such lease clauses also set valuation procedures for the determination of the new rent (usually arbitration) that involve professional appraisers in some capacity, as arbitrators, witnesses, or experts, so that the rules of appraisal take a hand. If a professional appraiser is asked to establish the value of a piece of land, a key consideration will be determining highest and best use.[13]

Highest and best use represents the reasonably probable legal use that is physically possible, is financially feasible, and results in the highest value.[14] Highest and best use may be viewed in either of two ways: the use "based on the presumption that the parcel of land is vacant" or "the use that should be made of the real estate as it exists"[15]—that is, as improved. This is frequently the key issue in rental reset value disputes. Much of the angst associated with Midtown Manhattan office building reappraisals comes from the fact that the land, if vacant and unimproved, would be more valuable for other uses, such as luxury residential, rather than office space.[16]

Select Case Law History

Most of the case law regarding rent reset reappraisals for land leases has turned on the same issue: should the land be valued as currently used or for some other higher and better use.

5. Pollem, Jellinek, and Stafford, *Ground Leases and Leasehold Interests in CMBS*.
6. TDR Staff, "Aby Rosen Seeks to Rework Chrysler Building Ground Lease," *The Real Deal*, May 6, 2020.
7. Pollem, Jellinek, and Stafford, *Ground Leases and Leasehold Interests in CMBS*.
8. TDR Staff, "Aby Rosen Seeks to Rework Chrysler Building Ground Lease."
9. SkyscraperPage.com Forum, "S. L. Green Moves to Push Ashkenazy out of 625 Madison," June 9, 2023.
10. Kathryn Brenzel, "Rethinking the Ground Lease," *The Real Deal*, June 8, 2022, 6. That estimate was later said to be "quite a bit lower" based on market conditions. Kate King, "Office Turmoil Roils Ground-Lease Negotiations," *The Wall Street Journal*, July 4, 2023, https://bit.ly/47r8buS.
11. 2 Misc.2d 631 (N.Y. Sup.Ct. 1956), aff'd 2 A.D. 970 (1956).
12. *Ruth v. S.Z.B. Corp.* at 634.
13. Appraisal Institute, *The Appraisal of Real Estate*, 15th ed. (Chicago: Appraisal Institute, 2020), 34–35 (hereinafter, *The Appraisal of Real Estate*).
14. *The Appraisal of Real Estate*, 305–306.
15. *The Appraisal of Real Estate*, 307–308.
16. Geiger, "Ground Wars." The appropriate "use valuation" in the context of ground lease rental resets might be something of a hybrid: that is, the land would be valued as if vacant but with the hypothetical condition that the permitted use is the current use or, perhaps, any uses to which the existing improvements can be efficiently adapted.

In *Ruth v. S.Z.B.*,[17] the land at 61st and Third Avenue in Manhattan held a retail building and some brownstones, but it was more valuable for office or residential uses.[18] The lease restricted any change in use by the tenant or modification of the improvements, so the tenant argued the valuation should be limited to the current uses and improvements.[19] However, the lease's reappraisal clause included the phrase "free of lease," so the court concluded that restrictions in the lease did not apply and other hypothetical uses should be considered.[20] The court noted that similar clauses had been in use for years in long-term leases, but there was little authority on their meaning.[21]

In *United Equities v. Mardordic Realty*,[22] the land at 64th and Third Avenue was improved only with a garage, but it was more valuable for other uses. The reappraisal clause did not state that value should be determined "free of this lease," nor did the lease restrict use of the property by the tenant.[23] The court concluded that the appraisers should consider whatever uses might be best made of the property, subject to the applicable terms of the lease, including the remaining 21 years of the term and the one renewal term of another 21 years, holding that the "only limitation on value, if any, is the number of years the most advantageous use of the land can be enjoyed under the lease."[24]

In the 1967 case *Plaza Hotel Associates v. Wellington Associates*,[25] the lease limited the land to use as a hotel, although the land was much more valuable for use as a high-rise office building.[26] The reappraisal clause did not include the clause "free of this lease," and the court held the property must be valued as restricted to hotel use.[27]

From these and subsequent cases, it might be said that the "New York Rule" is that absent a clear indication to the contrary, the rent reset valuation of land must take into account any restrictions on use and any other relevant provisions of the lease.[28]

On the other coast, the "California Rule" can be described as presuming that references to the "value" of the land mean fair market value in a standard appraisal at its highest and best use, not limited by any use restrictions in the lease or by the nature of the existing improvements, unless a clear intention to the contrary appears from the lease.[29] This rule grew out of two cases where there were no applicable use restrictions in the leases and no requirement that value should be determined "free of this lease." In the 1958 case *Bullock's, Inc. v. Security-First Nat'l Bank of L.A.*, involving a Los Angeles department store, the lease called for rent equal to "five percent of the appraised value of the leased land."[30] The court held that "value" meant fair market value and not use value, and that if the parties had meant anything else, then "they would have said so expressly."[31] In a second decision, *Eltinge & Graziadio Dev. Co. v. Childs*,[32] the California courts held that the lease's reappraisal language stating there

17. 2 Misc.2d 631. This conflict has manifested in American law for at least 150 years. See Jerome D. Whalen, "A Brief History of Ground Rent Resets," *PLI Chronicle*, September 2023, https://bit.ly/48mfmFZ.
18. 2 Misc.2d 633.
19. *Ruth* at 634.
20. *Ruth* at 635–637.
21. *Ruth* at 635.
22. 8 A.D.2d 398 (1959), aff'd 7 N.Y.2d 911 (1960).
23. *United Equities* at 399–400.
24. *United Equities* at 401–402.
25. *Plaza Hotel Associates v. Wellington Associates*, 55 Misc.2d 483 (Sup. Ct.). aff'd 2 A.D.2d 1209 (1967), 22 N.Y.2d (1968).
26. *Plaza Hotel Associates* at 486.
27. *Plaza Hotel Associates* at 487–488.
28. Jerome D. Whalen, "Reappraisal of Ground Rentals," *Probate & Property* 30, no. 3 (May/June 2016): 44, 46.
29. Whalen, "Reappraisal of Ground Rentals."
30. *Bullock's, Inc. v. Security-First Nat'l Bank of L.A.*, 160 Cal. App. 2d 277, 281, n. 1 (Cal. App. 1958).
31. *Bullock's, Inc.* at 188–189.
32. *Eltinge & Graziadio Dev. Co. v. Childs*, 49 Cal. App. 3d 294 (Ct. App. 1975).

shall be periodic appraisals of the demised premises (exclusive of improvements)" called for "appraisals of the fair market value…in accordance with its highest and best use as if vacant and without regard to the terms and conditions of the subject ground lease." Here, the California court specifically rejected consideration of the New York *Plaza Hotel* decision.[33]

Appraisal Issues

A highest and best use appraisal either as vacant or as improved should consider the *financial feasibility* of any alternative uses.[34] An appraisal of the property as it exists should presumably include the cost to obtain new entitlements, resolve existing, continuing leases, the cost of demolition and the loss of income during reconstruction as well as consideration of the alternatives of renovation or redevelopment of the existing structures. *The Appraisal of Real Estate*, fifteenth edition, states, "For any of [the] alternatives to be financially feasible…the value after conversion, renovation, or alteration less the costs of the modification (including entrepreneurial incentive) must be greater than or equal to the value of the property as is."[35] The lease language "vacant and unimproved" seems to obviate most of those considerations, requiring the appraisers instead to imagine bare land ready for redevelopment of the highest and best use. (Of course, any reappraisal would need to specifically exclude the value of the ground lease tenant's improvements for purposes of determining the new rental.)

One could conclude that the problem with ground lease reappraisal provisions is not reappraisals per se but rather the terms and the language of these provisions—usually written by lawyers and, in litigated cases, interpreted by judges. It seems odd that this language has been accepted until recently by so many attorneys for tenants and their leasehold mortgagees, notwithstanding more than sixty years of litigation. Today, however, many lenders seem to be rejecting any reappraisal clause on any terms without reference to the specific language.[36] This is a problem not only for ground lease tenants but for landlords as well. Prospective landlords are being told that rent reappraisals are not financeable and that they must rely on inflation indexing for rental adjustments. Even some landlords under existing ground leases are being asked by their tenants for relief from looming rent resets that are creating problems for renewing or refinancing mortgages. Eliminating value-based rent resets will likely favor ground lease tenants in the long run, not landlords.

This problem with reappraisals of ground leases has been apparent since at least the 1950s, from litigation related to Bullock's Department Store, the Plaza Hotel, the Lever House, the Chrysler Building, and One Penn Plaza, and these ground lease reappraisals have sometimes resulted in dramatic ground rent increases. Many more of these contests are conducted in arbitration or appraisal proceedings that never become public. Still, the same conflict keeps emerging: the value of the land as used pursuant to the lease, or the value as if "vacant, unimproved, unencumbered and free of this lease." Another way to state the issue comes from the dissent in *United Equities*, which states: "The purpose of such valuation clauses is to reimburse the owner for the value of his land, not to determine the economic rent the tenant can profitably afford to pay."[37] This briefly states the economic nature of the conflict, but it also assumes the conclusion.[38]

33. *Eltinge & Graziadio Dev. Co.* at 298, 299.

34. *The Appraisal of Real Estate*, 313–315.

35. *The Appraisal of Real Estate*, 314.

36. DBRS Morningstar, a credit rating business that rates debt for CMBS offerings, states that it "red flags" any ground leases securing rated debt with "market-based" rent resets, "especially if not easily quantifiable." Pollem, Jellinek, and Stafford, *Ground Leases and Leasehold Interests in CMBS*, 6. Joshua Stein, a frequent commenter on ground lease issues, has published *Model Ground Lease Criteria for CMBS and Other Lenders*, which would specifically prohibit any rental adjustments "based on any formula involving appraisal, valuation, or other contingent value-based review." *The Practical Real Estate Lawyer* (May 2021): 11, 14.

37. *United Equities* at 404.

38. The California court in *Wu v. Interstate Consolidated Industries*, 226 Cal. App. 3d 1511, 1515 (Cal. App. 1991), assumed the opposite conclusion. The *Wu* court, distinguishing *Bullocks, Inc.*, found that "the purpose of the renewal clause is to benefit the lessee…ensuring an opportunity to continue its business and recoup its investment."

A Note on "Free of This Lease." In a reappraisal late in the term of a ground lease, with only twenty or thirty years of remaining term, it would be very difficult to finance any substantial improvement or redevelopment of a project to its highest and best use "free of this lease." There simply would not be sufficient remaining years in the term to satisfy a leasehold mortgage lender or to provide a return on the investment to the tenant. In *United Equities*, the dissent notes that "the point, to whatever extent it may have validity, becomes almost immaterial, since there is a possible term of 42 years involved which will support the amortization of most, if not all, buildings constructed for profit, or just short of it."[39] This statement almost proves its opposite: it should be an issue for the appraisers whether a 42-year term would support (in terms of available financing and return on investment), for example, a concrete and steel office or apartment building, or a low-rise retail building, or a McDonald's. But "free of this lease" may eliminate this concern in the reappraisal.[40]

A Note on "Unencumbered." "Unencumbered" by itself can be interpreted to mean "free of this lease," as well as free of other "encumbrances."[41] A lease is actually something more than an encumbrance; it creates an estate in land, both a contractual interest and a property interest,[42] and an "interest" under federal bankruptcy law.[43] In this context, "unencumbered" is at best equivocal. Certainly, financial liens, mortgages, labor and material liens, and other liens that can be satisfied by the payment of money, that may affect equity but not the market value of the real estate, should be ignored in valuation of the land. But other title matters, that a lawyer would consider "encumbrances," that would continue to affect the property after a conveyance, and that cannot normally be dismissed by the payment of a determinable sum of money, may need to be considered in any appraisal. Easements, for instance, may benefit or burden the property, or add or detract from its value. There does not seem to be any controversy that easements, restrictive covenants, and similar title matters, whether private or governmental, should be considered by the appraisers, even if considered "encumbrances" in some other context. That is the position of the appraisal profession,[44] and there does not appear to be any case law to the contrary.

Both zoning and governmental restrictions have affected determinations of value in disputed cases, without reference to whether they constitute encumbrances. Zoning is critical to the determination of any possible legal uses of the subject property.[45] In *New York Overnight Partners v. Gordon*,[46] the land under the (then) Ritz-Carlton Hotel was the subject of a ground lease providing for a rent reset by appraisal of the land value, excluding "the buildings and improvements thereon."[47] Under the then-existing zoning, the property was allowed a building area of only 82,000 square feet, while the hotel comprised 152,000 square feet.[48] The court held that the land only should be valued without reference to the existing (legal, nonconforming) building.[49] A

39. *United Equities* at 404.

40. If "free of this lease" is not in the ground lease, at least in New York, that has the effect of imposing restraints on the tenant for purposes of the reappraisal, depending on the terms of the lease, including time restraints, i.e., the length of the remaining term, any use restraints set in the lease, and potentially others, resulting in a "restricted highest and best use" analysis for the appraiser. Tony Sevelka, "Ground Leases: Rent Reset Valuation Issues," *The Appraisal Journal* (Fall 2011): 314, 316.

41. *Evans v. Faught*, 231 Cal. App. 2d 703, 709–710 (Cal App. 1965), holding a lease as a breach of a covenant against "encumbrances"; Sevelka, "Ground Leases," 318, n. 11 and 320, n. 20.

42. Cornell Law School, Legal Information Institute, "leasehold," https://bit.ly/3HulzUJ.

43. *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, 327 F. 3d 537, 545 (7th Cir. 2003).

44. *The Appraisal of Real Estate*, 5, 11, 64–65.

45. *The Appraisal of Real Estate*, 308–310, 341, 348; Sevelka, "Ground Leases," 318.

46. 88 N.Y.2d 716 (1996).

47. *New York Overnight Partners*, 718–719.

48. *New York Overnight Partners*, 720.

49. *New York Overnight Partners*, 722.

California case,[50] applying the California Rule, rejected an existing use valuation for market value, but also held that the appraisal must consider the effect of restrictive laws and ordinances on the conversion of the tenant's mobile home park to any other use.[51]

Of course, the lease can require valuation of the property on any basis to which the parties agree. For example, a ground lease for a McDonald's restaurant in Canada provided for periodic reappraisals of the land value based on its hypothetical use for a modern single-story warehouse containing 20,000 square feet of usable space.[52] Such a valuation might be required in the ground lease without regard to any restrictions on use in the lease or under applicable laws, including zoning ordinances and other restrictions affecting the property. But if that is the parties' intent, it needs to be explicit.

Alternative Approaches

Prospective ground lease tenants and leasehold mortgagees have lately been seeking alternative means to satisfy landowners who will not enter long-term ground leases without some protection against inflation. One such approach has been indexing.

Inflation Indexing. There are a variety of indexing schemes that have been proposed to protect landlords against the devaluation of the rental income due to inflation; these are also designed to protect tenants and leasehold lenders from unpredictable and potentially unlimited rent increases. One typical provision might be for a fixed rent for the first five or ten years of the term, with an inflation adjustment after year five or ten employing the Consumer Price Index (CPI), subject to a cap—maybe 2% or 3% a year compounded, or 20% or 30% after ten years not compounded, and similar adjustments every five or ten years after that. Another fairly common suggestion is 2% per annum each year after year one, without regard to actual inflation, relying on the Federal Reserve's target rate for inflation.[53] Actual average annual inflation since 1913 (when the CPI was first issued) has been 3.14%,[54] and since 1971, 3.92%,[55] so that sometimes 3% or 3.5% is suggested.[56]

The variations are virtually infinite.[57] Traditionally, inflation indexing with caps or fixed-rate increases have been used for fairly short periods, five or ten or so years prior to a reappraisal or other rent adjustments, and for the years between later adjustments. Current indexing proposals would control for the entire term of 99-year ground leases. During any 99-year period there are bound to be one or two or more periods of high inflation.[58] For this, some propose "catch-ups," where increases denied by the cap in years when inflation exceeds the cap are credited to the landlord in later years when inflation is less than the cap.[59]

These are complicated provisions and at the least delay rent increases to the landlord in order to protect the tenant and the leasehold lender. The cost to the landlord depends on a number of factors: the size of the cap, the length and extent of inflation, whether high inflation occurs early in the term and with what frequency, and detailed variations in the indexing formula and the catch-up provisions.[60] Prospective landlords may not appreciate the degree to which various

50. *Humphries Invs., Inc. v. Walsh*, 248 Cal. Rptr. 800 (Ct. App. 1988).

51. *Humphries Invs., Inc.*, 803–804.

52. Sevelka, "Ground Leases," 315, n. 6.

53. See, for example, K. King, *Office Turmoil Roils Ground-Lease Negotiations*, July 4, 2023, 6, https://bit.ly/47r8buS.

54. In 2013, dollars.com/us/1913.

55. In 2013, dollars.com/au/1971.

56. See, for example, Joshua Stein, "Solving the Ground Lease Problem," *Lexology*, November 4, 2019.

57. For several indexing schemes and their possible effects over 40 or 50 years of actual inflation experience, see Jerome D. Whalen, "Indexing Ground Rents: A Closer Look," *The Practical Real Estate Lawyer*, 39 no. 5 (September 2023): 11, https://bit.ly/3twIoUp.

58. Whalen, "Indexing Ground Rents," Chart 1, 17.

59. Whalen, "Indexing Ground Rents," 13–15.

60. Whalen, "Indexing Ground Rents," 13, "Catch Up to What?"

elements of indexing proposals will affect the value of their rental income; the caps, periodic rather than annual rent adjustments, and non-compounding rather than compounded increases will each reduce future rent increases. The 2% per year formula is justified by the Fed's stated policy for an inflation target, now adjusted to "2% over the long run," and may be up for reconsideration in the foreseeable future.[61] It would be prudent to treat the 2% target as a floor on inflation rather than a prevailing condition and rely instead on the rates of inflation over the past fifty or one hundred years as a better indicator.

It has been suggested that "landlords just have to live with the risk of hyperinflation if they want to sign modern ground leases."[62] Prior to 2021, inflation in the United States was low to moderate for nearly thirty years, but the recent 2021-to-2023 era has changed that dramatically. Consequently, CPI indexing with low caps over extended lease terms, or fixed-rate increases at 2%, may no longer be acceptable. The prospective landlord must decide whether the likely cost will be justified by the benefits of a ground lease, including a potentially long-term highly secure income with the eventual reversion of the real estate. Explorations of indexing over fifty years of actual inflation experience seem to indicate that with all the variations in indexing formulae and all the possible future patterns of inflation, the cost to the landlord may range anywhere from tolerable to disastrous, and with no recourse, possibly for a hundred years.[63]

The "Modern" Ground Lease. Recently there has been much exposition of the "modern" ground lease, not particularly with reference to the rental reappraisal problem but relevant to it; eliminating market-based resets is consistent, even necessary, with the modern ground lease. One academic view suggests that a better structural approach is needed to revitalize the "antiquated ground lease industry" and describes some current modern ground lease terms to accomplish that goal: view the landlord as a passive investor seeking secure returns competitive with or better than bonds or preferred stock; with property level operating cash flow before debt service and ground rent at least three times the ground rent; initial rent priced at the ten-year Treasury rate (or equivalent) plus 1%; annual rent increases of 2.5% to 3.5% compounded; tenant purchase rights on the land at the end of the investor/landlord's investment period, at year ten, twenty, or thirty; limited landlord approval rights; and no market-based rental resets.[64]

This model is apparently aimed at the typical bond investor, but many features are inappropriate for or even antithetical to the traditional ground lease landlord, as discussed later. It seems that this structure would best fit completed projects with stabilized occupancy and returns, particularly in view of the pricing. As often happens, the property owner can sell the land to an investor subject to the ground lease, giving a predetermined, secure return over the landlord's investment horizon in a form that could also be financed by the landlord. The tenant retains the property operations and ultimate control. This seems a perfectly good investment vehicle for a certain type of investor, while providing the tenant with cash to reduce debt and/or equity in the project or for other purposes, at a cost, in terms of ground rent, perhaps less than the costs of additional debt or equity in current markets.[65] The rates of return suggested by Carr do not seem likely to attract construction financing, although others have written that this mechanism can be and is being used for that purpose, even preconstruction financing for development costs for land carry, permitting, and related expenses.[66] Even if the project does not go forward, the investor would own the land to protect

61. Jeff Sommer, "The Fed Has Targeted 2% Inflation. Should It Aim Higher?," *New York Times*, March 24, 2023, https://bit.ly/3S4mT6B.

62. Joshua Stein, "How Ground Leases 2.0 Create Value and Avoid Disaster," *Forbes Real Estate*, June 26, 2020, https://bit.ly/48l4HeC.

63. Whalen, "Indexing Ground Rents: A Closer Look."

64. Christopher Carr, "An Argument for the More Widespread Use of Ground Leases in the United States: How to Align Pertinent Interests and Strategically Implement on an Impactful Scale" (master's thesis, MIT, February 2023), 21–26, https://bit.ly/3RNeO5a.

65. See, for example, Pollem, Jellinek, and Stafford, *Ground Leases and Leasehold Interests in CMBS*, 2.

66. Danielle Ash, "The Modern Ground Lease Is a Compelling Option for Construction Financing," Globe Street, August 24, 2022, https://bit.ly/47tQlYh.

the investment. It has been observed that "while the traditional ground lease was, almost by definition, a long-term deal for the landlord, intended to protect its interest in perpetuity—modern landlords approach the deals from the perspective of an equity investor, and will look to sell or monetize their position after a few years, e.g., when the building is constructed and the lease default risk is further minimized."[67] This could be a good opportunity for investors willing to assume some risk for the potential of sharing in the bonus returns of a successful development project.

The "Traditional" Ground Lease Landlord. Traditional ground lease landlords have always been an eccentric class in the real estate industry, an exception to the more financially oriented investors, lenders, and developers who typify the profession. They tend to be attached to the land they own. It might have been inherited, or the site of a one-time family business, or acquired through years of assemblage. They may own more property adjacent to the ground lease parcel. They do not want to sell the land. They have faith in real estate as a long-term investment, perhaps more than in the stock or bond markets, or they see real estate as an important diversification from other investment vehicles.

As investors, these landlords want leases that provide reasonable returns over distant time horizons, with protection against inflation and with reasonable approval rights regarding the operation of the real estate, especially major changes. They want stable, secure rentals and a financeable ground lease interest, with continuing ownership and eventual reversion of the land for their descendants. They want assurance that the improvements will be maintained and renovated or redeveloped over the term of the lease, as needed to stay competitive. Although they might grant a right of first offer to the tenant in the event of a sale of the land, typically they do not grant options to purchase to anyone. They are not seeking to become passive bond investors, and their investment objectives are longer than ten, twenty, or even thirty years. The "modern" ground lease is a potentially great vehicle for those seeking certain kinds of investment opportunities; but for these landlords, it is not seen as a substitute for the traditional ground lease or a solution to the ground lease problem.

Rewriting Reappraisal Clauses

Another approach to the ground lease problem is to rewrite the reappraisal clauses that have caused so much trouble to avoid pricing the land under existing properties that no one wants to demolish and imposing rental rates that otherwise viable properties cannot afford to pay. Rewriting the traditional reset clause may require some years to muddle through; many specific issues will need to be addressed in a manner acceptable to landowners, developer/tenants, leasehold mortgage lenders, and attorneys for all of them. Following are a few ideas that might contribute to a solution.

Use Value. Standard appraisal practice suggests one alternative: use value. *Use value* is the "value of property based on a specific use, which may or may not be the property's highest and best use. If the specified use is not the property's highest and best use, use value will be equivalent to the property's market value based on the hypothetical condition that the only possible use is the specified use."[68]

This is the obvious alternative to reappraisal clauses that, in effect, call for highest and best use valuations, whether intentionally or inadvertently. There is nothing in the case law that would prohibit use valuation as the basis for a rental reset, provided that it is spelled out clearly and unmistakably in the lease.[69] Use valuation is frequently employed under state and local laws that base assessed valuation on existing uses for certain protected properties, such as historic buildings and agricultural and timber lands.[70] In most of the cases and reappraisals previously

67. Ash, "The Modern Ground Lease," 3.

68. Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 7th ed. (Chicago: Appraisal Institute, 2022), s.v. "use value."

69. See, for example, *Bullocks, Inc.*, 188–189.

70. Charlie Elliott, "Value in Use Appraisal, Addressed," Elliottco.com (March 29, 2018), https://bit.ly/3TR6qUz. Note, appraisals for specific purposes, like condemnation and real estate tax purposes, must satisfy applicable local laws.

discussed, a use value appraisal would have avoided some of the effects that followed.[71]

A use valuation should protect the tenant and the leasehold mortgagee from rental increases that the existing improvements cannot afford to pay, based on some other, hypothetical use, but still afford to the landlord a rental adjustment appropriate for the use of their property. These considerations are much the same as those that drive the initial rent agreement by the parties. When a landowner signs a long-term ground lease anticipating the construction of improvements with expected useful lives of many decades, the land has been committed to that use for at least the necessary period required to finance the development and return to the tenant the costs of the project and a return on investment; but it should not mean that the landlord has to absorb ruinous inflation over a 99-year term as the price of the deal.

Lease Term Considerations

One issue in rethinking ground leases might be the term length of the lease. Many tenants and lenders insist on 99-year terms for new ground leases, even though there is no legal reason for the choice: 50 years or 150 years would be just as good under the laws of most states.[72] The choice of term often is not reasonably related to the expected useful life of the improvement. If the Plaza Hotel, the Chrysler Building, and the Empire State Building can survive for a century, certainly many of today's new buildings, constructed under modern building codes, can do so as well. Of course, these buildings all required periodic capital investment to remain economically viable.

Other projects will not last for the terms of their ground leases and are not expected to. Excessive ground lease terms are demanded for all sorts of structures—retail, lodging, entertainment, industrial, storage, and others. It may not be appropriate that use valuation be maintained throughout a 99-year ground lease regardless of the condition of the improvements. The ground lease tenant should not be permitted to drain the last cash flow from antiquated buildings, in effect subsidized by a below-market ground rent based on the use value of obsolete structures.

The lease should require sufficient maintenance, improvements, and upgrades to the improvements throughout the term; compliance with this could be a condition to continued use valuations for rent reappraisals when the current use is not the highest and best use of the land.[73] If the useful life of the initial improvements is materially less than the ground lease term, then at some point the tenant should redevelop the property or sell to someone who will, and the rent should be reset to reflect the value of the land as part of the redevelopment. Similarly, if the initial improvements are materially expanded or there is a material change in use, the rent should be reset on a use value basis to reflect those changes. Perhaps the continuation of use value reappraisals should be set for a limited period of years, enough to accommodate financing, subject to extension if the tenant maintains the improvements in accordance with the lease and makes improvements and upgrades as needed for the property to remain economically viable. When that is no longer feasible, then redevelopment would be required or the land would be revalued as vacant and available for redevelopment at its highest and best use.

71. There are a few decisions from states other than New York and California—no more than one in any jurisdiction—holding for valuation of the property as used by the tenant rather than highest and best use, because the landlord approved or knew of the tenant's intended use, e.g., *Certain v. Kovens*, 314 So. 2d 184, 187 (Fla. Dist. Ct. App. 1975), or based on an implied obligation of good faith and fair dealing on the part of the landlord, e.g., *Cook Assocs., Inc. v. Utah Sch. & Institutional Tr. Lands Admin.*, 243 P.3d 888, 898–899 (Utah Ct. App. 2012).

72. The reason for 99-year terms is obscure. Wahl, "Why a 99-Year Lease?," *Florida Bar Journal* 29 (1955): 548. Alabama and Nevada, at least, have statutes limiting leases to 99-year terms. AL Code Sec. 35-4-6 (2018); Nev. Rev. Stat. Sec. 111.200 (1999). In common law jurisdictions, a perpetual lease should be legal, if the lease clearly allows the tenant to renew forever. R. D. Mellem, "Perpetual Leases in Washington," Wash. State Bar Assn., *Real Property & Trust Newsletter* 29, no. 2 (Summer 2001).

73. Tenants and leasehold lenders typically resist stringent maintenance and repair clauses beyond "in compliance with applicable law." If the ground lease requires adequate maintenance and periodic capital investment to remain competitive in the market as a condition to the continuing use valuation, the inevitable disagreements likely would require arbitration or the like to resolve. Generally, see Jerome D. Whalen, "Ground Leases: The End Game (With Draft Replacement Reserve Clause)," *The Practical Real Estate Lawyer* (July 2022): 31–36.

Probable Useful Life. Tailoring the length of ground lease terms to the probable useful lives of the improvements might eliminate some of these complications that are the result of long lease terms. There is the opposite problem as well. Typically, after fifty years or more of the ground lease term, the tenant may possess improvements that need to be replaced or very substantially improved, but the remaining term of the lease is not sufficient to finance the work. Then the lease could provide that if the tenant (or a prospective successor) presents the landlord with a viable redevelopment plan with a request to extend the term for a reasonable period to enable the financing and a return on investment, the landlord should grant the request, or, if not, the use valuation would be extended for the existing improvements (which might still be subject to reasonable maintenance and updating).

Zoning Changes and Transferable Development Rights (TDRs). When highest and best use is the standard for reappraisals, changes in the applicable zoning for a property can play havoc with the valuation. Changes in zoning may allow buildings that are much larger than the existing improvements, or much smaller, or prohibit the current use altogether. Various forms of downzoning are common. Nearly four in ten buildings in Manhattan exceed existing regulations concerning density, height, setbacks, lot coverage, and the like.[74]

A use value appraisal should avoid most of these problems. For instance, if the existing structures are a legal, nonconforming use, that should be the basis for the reappraisal. However, if the existing buildings are materially smaller than the law allows, then even a use valuation may result in a value based on what is permissible—that is, a larger version of the same use—rather than what exists. The situation might arise from a zoning change or from the tenant's failure to fully develop the property. Normally, the landowner and tenant agree on the size of the project to be built and tailor the leased land to the appropriate size. But it may be difficult (approaching impossible) in some jurisdictions to change lot lines. Also, the tenant may plan development in phases, and be unable for financial, market, or other reasons to pursue the later stage or stages.[75] The lease needs to address how any unused development rights are to be valued or revalued and, if any rights are transferable, who has the right to transfer or sell the TDRs, recognizing that the applicable law may change over time.

Historic Structures. Sometimes historic buildings are not amenable to dramatic structural changes or demolition that might be required to adapt the land to a more valuable use. Often, historic buildings can be changed in use. Railroad depots can become office or performance venues or art centers while preserving the historic features, but necessarily there are limits to the acceptable alterations. Use valuations may deal with this, and also create other issues. Local codes vary; some will not impose mandatory controls on certified historic structures but provide incentives such as tax credits and transferable rights, as long as certain conditions are met.[76] The ground lease needs to address specifically the applicable regulations. If the structure is intended or required to be preserved, the ground lease landlord will likely pay a price for the historic designation in terms of limited valuation alternatives.

Conclusion

Use valuation is more a goal than a technique, although the concept is recognized by the appraisal profession and there has long experience in certain specialized areas. Still, the parties in a new ground lease would need to spell out in some detail what they intend, addressing the issues they can identify, such as those addressed in this discussion as well as the circumstances of their property. Each ground lease transaction is different. This would add further complications to an already complicated ground lease document.

74. Quoctrung Bui, Matt A. V. Chaban, and Jeremy White, "40 Percent of the Buildings in Manhattan Could Not Be Built Today," *New York Times*, May 20, 2016, https://bit.ly/3UbCtPh.

75. Standard appraisal practice would include market analysis to determine if a larger project on the property would be financially feasible. See *The Appraisal of Real Estate*, 34, and chapters 15 and 16.

76. Emma Brandt Vignali, "Historic Districts: Preserving the Old with the Compatible New," *Wm. & Mary L. Rev.* 59 (October 2017): 345–86.

The ground lease industry has not addressed the reappraisal issues despite obvious manifestations of the problems for decades.[77] Inflation indexing and the "modern" ground lease are not solutions to the problem for the traditional ground lease landlord, but there are ways, with some constructive thought and careful drafting, to address these issues. The "modern" version of the traditional ground lease will need to provide periodic reappraisals to accommodate many owners of desirable parcels who are open to ground lease proposals. Those reappraisal clauses will need to deal realistically with the landlords' and tenants' and leasehold lenders' concerns regarding rental resets and related issues.

About the Author

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Additional Resources

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

Appraisal Institute

- **Education**
  - Advanced Land Valuation: Sound Solutions to Perplexing Problems
  - General Appraiser Site Valuation and Cost Approach
  - Residential Site Valuation and Cost Approach

- **Lum Library, Knowledge Base [Login required]**
  - Information files—Land and site, leases and leaseholds
  - Information files—Value

- **Publications**
  - *The Appraisal of Real Estate*, fifteenth edition
  - *Land Valuation: Real Solutions to Complex Issues*

77. In the 1950s, the first "modern" court cases appeared in New York and California when commercial ground lease financing seems to have matured. See H. A. Mark, "Leasehold Mortgages—Some Practical Considerations," 14 *Business Lawyer*, 609 (1959). Reappraisal disputes much like those considered here go back much further in the legal reports. See Whalen, "A Brief History of Ground Rent Resets," *PLI Chronicle*, September 2023.