From the Ground Up: Ground Lease and Rental Arbitrations

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Ground Leases – the Basics

• Ground Leases are typically long-term arrangements

• Landlord retains title to the property

• Tenant typically owns the improvements

• The land – including improvements – generally reverts back to the Landlord at the end of the lease
Ground Leases – Rent Renewal

- Typically a Landlord gets a fixed percentage of the value of the land at the time of renewal, excluding the value of improvements.

- The parties to the lease set the terms of rent renewal or review.

- As a matter of law, the intent of the parties governs the interpretation of the lease in any dispute.
Ground Leases – Rent Renewal

- In a perfect world, the parties would clearly state the basis for the rent renewal exercise
  
  **Example:** “Value the Land at its highest and best use, vacant and unimproved, and unencumbered by this Lease…”

- In practice, few if any rent renewal clauses are as clear as they could – or should be
  
  **Example:** “rent shall be based on the appraised value of the land”
Ground Leases – Rent Renewal Arbitrations

- Most leases provide for binding arbitration if there is a disagreement about rent at renewal
- There are different types of ADR processes
- Parties will usually agree on the process and procedure
Ground Leases – Rent Renewal Arbitrations

- Appraisers are commonly appointed as arbitrators
- Depending on the issues, many rent renewal disputes are resolved by a panel of arbitrators
- Rules of evidence are relaxed in an arbitration but the format often resembles a trial
  - Opening Statements
  - Evidence-in-Chief
  - Cross-Examination
  - Reply
  - Closing Argument
Ground Leases – Rent Renewal Arbitrations

• Rent renewal arbitrations often require:
  • Documentary discovery
  • Examination for Discovery
  • Lots of Expert Evidence

• $$$
Ground Leases – Rent Renewal Arbitrations

• Almost all arbitrations that end up being reviewed in a Court of Law arise by virtue of poor drafting of the lease

• The rent renewal clause is often the focus of many disputes

• Courts will look to other parts of the lease in an effort to determine the “intent” of the parties

• Definitions sections are often important including what is – and what is not - defined
Ground Leases – Common Areas of Dispute

• “Highest and best” use or “current” use?

• Ignoring or taking into account the terms of the existing lease, including use restrictions?

• Value as freehold or leasehold (for the remaining of the terms of lease)?

• Impact of new zoning or land use regulation on value
Ground Leases – Rent Review Arbitrations

- Courts in New York and California have adopted two very different approaches establishing the intention of parties where one is difficult to find.

- “California Rule”: “value” means fair market value in a standard appraisal at its highest and best use, not limited by any use restrictions in the lease or the existing improvements – unless a clear intention to the contrary appears from the lease.

- “New York Rule”: use restrictions in the existing lease must be taken into account unless there is a clear indication to the contrary.
Ground Lease – Rent Renewal arbitrations

  (California Court of Appeal, 1958)
Ground Leases – Bullock’s

3050 Wilshire Blvd.
Los Angeles, CA
Ground Leases – Bullock’s
Ground Leases – Bullock’s

- At the time this was a department store called “Bullock’s Downtown”
- Tenant had occupied the space for some 50 years
- Rent renewal clause called for landlord to have rent set at 5% of the “appraised value of the leased land fixed as hereinafter provided…”
- The lease required the appraisal to cover the leased land, “exclusive of the buildings and improvements thereon…”
Ground Leases – Bullock’s

- Court found “appraised value of the leased land” means fair market value based on highest and best use
- Court rejected arguments like:
  - “appraised value” is not “market value”
  - value means value in use
  - use of the phrase “leased land” does not modify “value”
- To have some other basis for valuation, the lease must be clear
- Rent shot up almost 35% to tenant in Bullock’s
Ground Leases – Plaza Hotel

768, 5th Ave.
New York, NY
Ground Leases – Plaza Hotel
Ground Leases – Plaza Hotel

- Rent renewal clause: “an annual ground rental equal to 3% of the value of all of the land (wherever permitted by the context the word “land” as used herein is intended to mean the land only, exclusive of buildings and improvements thereon)”
- The lease did contain a use restriction – hotel purpose only
- Three appraisals prepared by both landlord and tenant – all agreed hotel use was not highest and best use
- All three appraisers ignored the existence of the lease, the use restriction in the lease, and the remaining term of the lease
Ground Leases – Plaza Hotel

- Court found that, in New York, valuations must take into account all encumbrances as to use unless a contrary intention is clear

- Court threw out all three appraisals and ordered new ones to take the use restriction in the lease into account
Ground Leases – New York Overnight Partners

• The presumption in New York that existing leases ought to be taken into account may be displaced by the language of the lease


• A dispute about the rent renewal for the Ritz-Carlton Hotel in Manhattan
Ground Leases – New York Overnight Partners

112 Central Park South
New York, NY
• Original Lease executed in 1963

• Initial term was 30 years at an annual rate of $78,000

• Rent renewal clause: “6 ½ per cent of value of the land [at the time of each renewal]”

• “land” was not defined in the lease
Ground Leases – New York Overnight Partners

• Defined terms: “improvements” (everything “but the land”); “demised premises” (the land); and “property” (both demised premises and improvements).

• Court concluded that “land” means “raw land absent any improvements”
Ground Leases – New York Overnight Partners

• A win for the Donald?

• Between the date of the original lease and the rent reset, the City downzoned the property to limit the size of any new building constructed on it

• The existing building was larger – and more valuable – than that which was permitted at time of renewal

• Court rejected the lessor’s argument that the non-conforming improvements could be taken into account
Ground Leases – The Canadian Experience

- *No. 100 Sail View Ventures Ltd. v. Janwest Equities Ltd.* (1993 – BCCA)

- 550 – 999 Canada Place in Vancouver
Ground Leases – No. 100 Sail View (1993)

550 – 999 Canada Place
Vancouver, BC
Ground Leases – No. 100 Sail View (1993)
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• Original lease signed in 1981

• Rent renewal clause:
  “a value of 10% of the fair market value of the Leased Premises as bare land at the date of review”

• Parties disagreed about whether the valuation should consider or ignore the existence of the lease and in particular the use restrictions in the existing lease

• BC Court of Appeal looked at all of the Case Law – including the New York and California ones summarized here
Ground Leases – No. 100 Sail View (1993)

- Court decided none of the cases were binding
- Use of the words “bare land” persuaded the BCCA to conclude the lease as well as the land use restrictions ought to be ignored
**Ground Leases – Pacific West (2004)**


- Rent renewal clause: “rental shall reflect a fair market rental on the date of...adjustment”

- BCCA held that the use restrictions on the subsisting lease must be taken into account

  “In the absence of express provision to the contrary, I see no basis on which it can be said that the parties to the lease can have intended that the tenant be put in a position of paying rent based on the unrestricted use of the lands when it is precluded from enjoying what may be the highest and best use”
Ground Leases – Victoria University (2016)
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• 131 and 151 Bloor Street West in Toronto
• Rent Reset Clause: “appraise and determine the fair market value of the demised lands”
• Landlord argued this meant disregard the lease and base the valuation on an unencumbered highest and best use of mixed commercial retail with freehold condominiums above
• Lessee argued that the remaining term of the lease and the fact it could not build freehold condos ought to be taken into account
Ground Leases – Victoria University (2016)

- Arbitration panel sided with the landlord and based FMV on mixed commercial retail with freehold condos above
- On appeal, it was held that the arbitration panel erred: the tenant could not build freehold condos so valuation could not be based on that
- The fact that the property was leased precluded freehold condos from being built
- Instead, the Court of Appeal in Ontario decided that:
  a) Fair market value requires the freehold interest not the leasehold interest to be valued;
  b) Fair market value must take into account land use legislation in force at the time of renewal;
  c) The fact of a lease in place, but not the terms of the lease, must be taken into consideration in establishing a Highest and Best Use

- The Decision is under appeal
Ground Leases – A Fair Way Forward

• Rent based on existing use during the economic life of the lessee’s asset

• Once the asset is obsolete, it is fair for a lessee to have to pay rent even if for a higher and better use

• Lessee may bargain for an exit if rent is set too high